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Social Security Taxation

Impacts on Farm Operations and Proposals for Tax Reform

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Keywords: Taxation, social security, farm management, investment.

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SUMMARY

Recent reforms have increased the social security tax burden on farmers and other self-employed workers. Benefits for future social security retirees may be reduced to keep the system solvent. Many young workers now face the prospect of receiving low or negative real rates of return on their social security tax contributions, and thus have an incentive to minimize the taxes that they pay.

The social security tax burden on self-employed workers is increased by the fact that the tax is levied on their business profits, which include income generated by their business capital as well as labor. Farmers pay social security taxes on their net farm profits, which include income that is attributable to the land, structures, equipment, and other capital that they own and use in their farm operations.

Some farmers are able to reduce their social security taxes by making adjustments in business operations and investments that reduce the amount of their income subject to the tax. Tax-saving adjustments may include: the reallocation of savings from farm to personal investments; the substitution of farm debt for personal debt; the cross-leasing of farmland, with owned land rented to others and replacement land rented from others; the breeding of larger numbers of gilts and heifers, and the culling of more sows and cows; and the incorporation of farm proprietorships and partnerships. Some self-employed workers in the nonfarm sectors of the economy can also make adjustments in their business operations and investments to reduce their social security taxes.

These tax-saving adjustments in business operations can often result in a misuse or misallocation of resources. Economic efficiency could be improved by changing the social security tax structure to eliminate the tax savings that encourage the use of these inefficient business practices.

Many of these tax-saving business practices involve an exploitation of the non-neutral social security tax treatment of the income earned by business versus personal investments, the latter of which are exempt from the tax. The social security tax structure could be made neutral across all investments by allowing self-employed workers to claim tax deductions that equal the rental value of their business capital. This would effectively eliminate the current social security taxation of the income earned by the business capital of self-employed workers. An alternative tax reform would be a shift in the social security tax base from income to consumption. This would impose an equal and neutral tax on the income earned by the business and personal investments of all wage, salary, and self-employed workers. All such income would be taxed to the extent that it was consumed and not saved.

Social Security Taxation

Impacts on Farm Operations and Proposals for Tax Reform

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INTRODUCTION

Self-employed farm operators are covered by the social security system. They now pay a social security tax of 11.3 percent of the first $37,800 of the net farm profit that they report on IRS (Internal Revenue Service) Form 1040 and Schedule F. This net farm profit includes income attributable to the land, structures, and equipment owned and operated by these farmers. Thus, up to a limit, the income from owner-operated farm capital is subject to both the social security tax and the individual income tax.

Although there is a rough relationship between social security taxes paid and benefits received, many of today's younger farmers may expect to receive a low or negative real rate of return on their social security contributions. These young farmers may be searching for ways to reduce or minimize their social security taxes. There are a number of methods by which farmers can reduce the social security taxes that they must pay on income earned by their capital. Most of the methods involve modifications of the investment or business behavior that would normally be most efficient for these farmers and for society.

The income earned by personal (nonbusiness) investments is exempt from social security taxation. Most of farmers' opportunities for reducing their social security taxes have been created by the non-neutral tax treatment of farm versus personal investments. Given the inefficiencies that can result from farmers' attempts to minimize their taxes, one could argue that the social security tax structure should be modified to equalize the tax treatment of all investment income.

The first section of this paper describes the social security tax structure and looks specifically at the taxation of the income of self-employed farmers. The second section discusses the relationship between social security taxes and benefits and concludes that many of today's younger workers will earn low returns on their tax contributions and may therefore seek to minimize their social security tax payments. The third section examines the effects of social security taxes on the investment incentives and business behavior of self-employed farmers, and discusses the inefficiencies and distortions that can result from farmers' attempts to minimize their taxes. The final section discusses several methods of equalizing the social security tax treatment of the income earned by the business and personal investments of farmers and other self-employed workers.

Self-employed workers were not covered by the original social security legislation. From 1936 through 1950, only wage and salary income was subject to social security taxation. Although some self-employed workers were brought under the system in 1951, coverage was not extended to self-employed farmers until 1955 (4). 1/ Farmers paid their first social security taxes in early 1956 when they filed their income tax returns for 1955.

Tax on Net Farm Profits

All farmers who are sole proprietors or members of partnerships are required to pay social security taxes on the net farm profits that they report on IRS Schedule F. 2/ The IRS has defined net farm profit to be gross receipts from the sale of crops and livestock produced on the farm, plus net profit (or loss) from the sale of livestock purchased for resale, minus farm production expenses, which include interest, sales and property taxes, and depreciation. Social security taxes on net farm profits are computed on Schedule SE and are added to farmers' Federal income tax liabilities on Form 1040.

Treatment of Capital Gains

Net farm profit (Schedule F) excludes a number of items of income reported on other IRS forms and schedules. The most important exclusion is that of gains and losses from the sale of land and depreciable farm assets. Depreciable assets include structures, machinery and equipment, and livestock (except poultry) held for draft, dairy, breeding, or sporting purposes. When land and depreciable assets are sold, gains and losses are reported on Form 4797 and Schedule D in lieu of Schedule F, and are thus exempt from social security taxation. 3/

While depreciable assets are being used in the farm business, they can be the source of tax depreciation deductions, which are claimed on Schedule F, and which reduce the net farm profits that are subject to social security taxation. 4/ When depreciable assets are sold, there is often a gain (when net sales price exceeds cost), or a loss that is less than the amount of the tax depreciation deductions that have been claimed. In either case, the excess tax depreciation deductions must be "recaptured" and taxed. The recaptured depreciation is computed on Form 4797, not Schedule F. It is subject to income taxation but exempt from social security taxation.

1/ Underscored numbers in parentheses refer to items in the References Section.

2/ The IRS tax forms and schedules mentioned in this report are reproduced in the appendix.

3/ If real estate and equipment are held for less than 1 year prior to sale, or depreciable cattle or horses are held for less than 2 years, or other depreciable livestock are held for less than 1 year, any gains from sale are considered ordinary gains, and are taxed at the same rate as ordinary income, instead of the reduced rate for long-term gains. Both ordinary and long-term gains are reported on Form 4797 and are exempt from social security taxation.

4/ Livestock that are born and raised on a taxpayer's farm have a zero basis and cannot be the source of tax depreciation deductions. However, they do fall in the category of "depreciable assets," provided that they are held for draft, dairy, breeding, or sporting purposes. The gains and losses from the sale of such livestock are reported on Form 4797.

Treatment of Rental Income

The income that farmers earn from renting out farmland and equipment is generally excluded from Schedule F and thus exempt from social security taxation. An exception is the rental income earned by farm landlords who materially participate in the operation of land which they have rented to tenants. This exception is based on the premise that many farm landlord-tenant arrangements are joint operations involving considerable activity on the part of the landlord. The IRS and the Social Security Administration have agreed upon a list of criteria used to determine if there has been material participation by a landlord. The following is a list of activities that reflect landlord participation: consulting with the tenant; inspecting production activities; paying half or more of the direct costs of producing a crop; furnishing half or more of the tools, equipment, and livestock used in producing a crop; participating in management decisions; and working on the farm 100 hours or more, spread over a period of 5 weeks or more. Landlords need not engage in all of these activities to meet the definition of material participation. In some cases participation in just one of the activities will suffice. 5/

When a landlord receives rents in the form of crop shares and materially participates with his tenant in the operation of leased land, the landlord's rental income and expenses are reported on Schedule F, and are subject to social security taxation. When a landlord receives share rents but does not materially participate in the operation of leased land, his rental income and expenses are reported on Form 4835, and on Schedule E, and are exempt from social security taxation. Income from cash-rented land is reported on Schedule E and is also tax exempt. 6/ However, cash rents and fees earned by providing pasture and water for the livestock of others are reported on Schedule F, along with associated expenses, and are subject to social security taxation.

Minimum Taxable Income

Farmers with net farm profits of $400 or more must pay social security taxes on those profits and must file Schedule SE and Form 1040, even if they would not otherwise be required to file a Federal income tax return. Those with profits of less than $400 who have no other income cannot pay social security taxes or receive credit for social security coverage unless they qualify by using the optional method of computation of self-employment earnings. The optional method extends social security coverage to some farmers who earn net farm profits of less than $400 per year. The method gives farmers the option of reporting a stated fraction of gross farm profits (Schedule F, line 31) as their earnings from farm self-employment. In 1955, the fraction was one-half, and farmers with gross profits of $800 or more could qualify for social security coverage even if their net profits were less than the $400 minimum. At present, the fraction is two-thirds, so farmers with gross profits of as little as $600 can qualify for social security coverage. 7/

5/ For a list of the tests used by IRS to determine whether a landlord is materially participating in the operation of rented land, see (20).

6/ O'Byrne and Davenport (14, p. 851) discuss the unusual case of a landlord whose cash rental income was ruled to be self-employment income (and subject to social security taxation) by virtue of the landlord's material participation. In such a case, the income would presumably be reported on Schedule F.

7/ Under this optional method, farm self-employment earnings are restricted to be no greater than $1,600. See Schedule SE, line 3.

Taxes on Other Income

In addition to the social security tax on net farm profits, farmers also pay social security taxes on farm and nonfarm wage income and other self-employment income. At present, maximum taxable income is $37,800. If wage income exceeds this amount, the excess and all self-employment income is exempt from social security taxation. If wage income is less than this amount, self-employment income is taxable up to the amount by which wage income falls short of the $37,800 limit.

Although farm proprietorships and members of farm partnerships pay social security taxes on net farm profits, there is no social security taxation of the net farm profits of incorporated farm businesses. However, farm corporations and their employees must each pay social security taxes on the wages and salaries paid to employees. The social security taxes paid by corporations are a deductible expense on corporate income tax returns.

Tax Rates and Maximum Taxable Earnings

In 1955, the social security tax rate for self-employment income was 3 percent, and the total tax rate for wage income was 4 percent, with half paid by employers and the remainder by employees. Maximum taxable earnings were only $4,200, and the maximum tax was only $126 for self-employed workers and and $168 for wage earners and their employers (table 1).

The tax rates and maximum taxable earnings have increased considerably over time. This year (1984), the tax rates for wage and self-employed workers are equal at 14 percent, but Federal income tax credits reduce the effective tax rates to those shown in table 1. Self-employed workers receive a 2.7-percent credit that reduces their effective tax rate to 11.3 percent, while wage earners receive a 0.3-percent credit that reduces their total tax rate to 13.7 percent. 8/ Maximum taxable earnings are now $37,800. This year's (1984) maximum self-employment tax is $4,271, and the maximum total employer/employee tax is $5,179.

The tax credit for wage earners is being dropped at the end of this year, but self-employed workers will receive tax credits of 2.3 percent in 1985 and 2 percent in 1986-89. These credits will keep the effective tax rate for self-employed workers below the total tax rate for wage earners.

In 1990, the tax credits will be eliminated and, for the first time, the effective tax rates for wage and self-employment income will be equal, at 15.3 percent. Beginning in the same year, two adjustments will be made in the method of taxing self-employment income to make it comparable to the method used to tax wage income. Self-employed workers will be given a social security tax exemption equal to 7.65 percent of earnings, and an income tax deduction equal to half of the social security taxes that they pay. The tax exemption and income tax deduction will compensate for the fact that employees

8/ The tax credits will not appear on Federal income tax returns. The government is using the effective tax rates to compute social security tax liabilities for wage earners and self-employed workers. The Treasury will make a lump-sum transfer of revenue to the social security trust fund to replace the additional revenue that the fund would have obtained if the 14-percent tax rates had been used.

Table 1--Social security tax rates, selected years

Year	Maximum taxable earnings	Self-employed: Tax rates	Self-employed: Maximum tax	Employers and employees: Tax rates: Each	Employers and employees: Tax rates: Total	Employers and employees: Maximum total tax
	Dollars	Percent	Dollars	Percent	Percent	Dollars
1955	4,200	3.00	126	2.00	4.00	168
1960	4,800	4.50	216	3.00	6.00	288
1970	7,800	6.90	538	4.80	9.60	749
1971	7,800	7.50	585	5.20	10.40	811
1972	9,000	7.50	675	5.20	10.40	936
1973	10,800	8.00	864	5.85	11.70	1,264
1974	13,200	7.90	1,043	5.85	11.70	1,544
1975	14,100	7.90	1,114	5.85	11.70	1,650
1976	15,300	7.90	1,209	5.85	11.70	1,790
1977	16,500	7.90	1,304	5.85	11.70	1,931
1978	17,700	8.10	1,434	6.05	12.10	2,142
1979	22,900	8.10	1,855	6.13	12.26	2,808
1980	25,900	8.10	2,098	6.13	12.26	3,175
1981	29,700	9.30	2,762	6.65	13.30	3,950
1982	32,400	9.35	3,029	6.70	13.40	4,342
1983	35,700	9.35	3,338	6.70	13.40	4,784
1984	37,800	2/ 11.30	4,271	3/ 7.00	13.70	5,179
1985	1/ 39,700	2/ 11.80	4,685	7.05	14.10	5,598
1986	1/ 41,700	2/ 12.30	5,129	7.15	14.30	5,963
1987	1/ 43,800	2/ 12.30	5,387	7.15	14.30	6,263
1988	1/ 45,900	2/ 13.02	5,976	7.51	15.02	6,894
1989	1/ 48,200	2/ 13.02	6,276	7.51	15.02	7,240
1990	1/ 50,700	15.30	7,757	7.65	15.30	7,757

1/ Maximum taxable earnings are tied to an index of wages. Figures for 1985-90 were computed under the assumption that the index rises 5 percent each year.

2/ Tax rates shown are effective rates that reflect adjustments for income tax credits. See text, p. 4.

3/ Nominal tax rate is 7 percent for both employer and employee. A 0.3-percent income tax credit reduces the effective tax rate for employees to 6.7 percent and the total rate from 14 to 13.7 percent.

do not pay social security taxes or income taxes on the value of the social security taxes that are paid by their employers.

Timing of Tax Payments

Federal income and social security self-employment taxes are collected on the same IRS Form 1040 or similar form. Farmers may wait until the end of the tax year to compute and pay both taxes. Other self-employed workers are required to make quarterly payments of estimated taxes whenever they expect to have a total income and self-employment tax liability of more than $300.

The IRS defines farmers as those who expect to earn two-thirds or more of their gross income from farming. Farmers have two options with regard to payment of taxes. Under the first option, they must file their income tax returns by March 1 following the tax year, and pay all income and self-employment taxes at that time. Under the second option, they must file preliminary returns by January 15, with full payment for any income and self-employment taxes that are estimated to be due, and then file final returns with final tax payments by April 15.

RETURNS ON TAX CONTRIBUTIONS

The social security system provides its participants with benefits that bear some relation to the tax contributions that individuals have made over their lifetimes. It is useful to look at the relationship between tax contributions and past or projected benefits when studying the effects of social security taxes on the financial positions of farmers and others. The relationship determines whether social security taxes are something to be minimized, as in the case of the income tax, or whether individuals can benefit from the payment of additional taxes. In many cases, the deciding factor is the difference between the real rate of return on social security tax contributions and the real rates of return on alternative investments.

Past Returns

Social security retirement benefits have been very generous in relation to taxes paid. Many past and current retirees have received (or will receive) a very attractive return on tax contributions. Some specific data on the rates of return received by past retirees have been provided by Freiden, Leimer, and Hoffman (5). They examined the earnings and benefit records of a sample of persons who retired between 1967 and 1970, and estimated that the average retiree earned a real rate of return on tax contributions of 14.8 percent. They found that the returns varied by income class. For the one-fourth of the sampled individuals having the highest lifetime earnings, the average rate of return was 8.4 percent, but for the one-fourth having the lowest earnings, the average was 25.2 percent.

It appears that self-employed farmers have fared as well or better than most workers under the social security system. In 1955, the year in which farmers were first covered by social security, Ellickson (4) examined the tax and benefit structure of the system and estimated that by 1957 the annual benefits to retired farmers and their dependents might exceed the annual tax contributions from active farmers. Ten years later, Reinsel and Ellickson (15) examined a sample of the social security records of farmers and estimated that farmers as a group may have received as much as $780 million in retirement benefits in 1961, while paying only $240 million in taxes.

There were three reasons why the farmers of the late 1950's and early 1960's earned such high benefits in relation to taxes paid. First, for a period of time following the extension of coverage to farmers, only 2 years of tax contributions were needed to qualify for retirement benefits. During this period, the average age of farmers was high (in relation to the averages for those in other occupations), so many farmers were able to retire soon after qualifying for benefits. Second, many of these farmers earned low net farm profits, but qualified for the minimum retirement benefit, which was high in relation to the minimum tax contribution needed to qualify. 9/ Third, the social security tax rate for these farmers and other self-employed workers was only three-fourths of the total tax rate for wage earners. 10/ Despite the lower tax rate, farmers and other self-employed workers received the same benefits as those wage earners who reported the same income.

Future Returns

Although most retired farmers and other past and current retirees have received attractive returns on contributions, there is an expectation that these returns cannot be maintained. Demographic projections indicate that the ratio of retirees to workers will continue to increase. Since the social security system is basically unfunded, operating on a pay-as-you-go basis, some combination of benefit reductions and tax increases will be needed to maintain the system. Regardless of the specific changes that are made, future retirees can expect to receive returns on tax contributions that are lower than those of current retirees.

Leimer and Petri (12) estimated the real rates of return on tax contributions that will be received by workers born in the years 1917 through 2000. They developed separate estimates of returns for each of four alternative policies for dealing with the longrun financing problem. Each policy involved some combination of tax and benefit adjustments. In general, they found that the rates of return were not greatly affected by the choice of policy. In almost all cases, the returns declined as year of birth increased. Those born in 1917 are expected to receive average real rates of return of about 7 percent. For those born in 1935, the returns are expected to average between 3 and 4 percent. Those born after 1950 are expected to receive real returns of between 2 and 3 percent.

These returns projected by Leimer and Petri are averages and thus hide differences among workers with varying amounts of lifetime income. Those born after 1950 who earn higher than average incomes might reasonably expect to receive real rates of return on contributions that are much less than 2 or 3 percent. For those who earn as much or more than maximum taxable social security earnings, the real rates of return on contributions could conceivably be zero or negative.

In the next section of this paper, we show that self-employed workers have some control over the amount of their income that is subject to social

9/ Under the system, as a worker's income and tax contributions increase, there is a less-than-proportional increase in retirement benefits, so low-income workers receive a higher return on their contributions.

10/ The explicit tax on wage earners is only half of the total tax. We assume that the employer share of the tax is passed on to employees in the form of lower wages.

security taxation. Through changes in the legal organization of business operations, and reallocations of physical and financial capital, self-employed workers can reduce the fraction of their income that is attributable to self-employment, and thus reduce their tax liability. The tax savings can be used for investments having prospective rates of return higher than those that workers expect to earn from social security.

The extent to which self-employed workers depart from standard business practices to achieve social security tax savings should be directly related to the difference between the rate of return on social security tax contributions and the rate of return on alternative investments. Melichar estimated that the real before-tax rate of return on farm production assets averaged about 8 percent from 1950 to 1980 (13). For many of today's young and middle-aged farmers, this far exceeds their expected rate of return from social security. Many farmers are likely making adjustments of business operations in attempts to reduce or minimize their social security taxes.

TAX MANAGEMENT AND ECONOMIC EFFICIENCY

There are a number of ways in which farmers can modify their investment and business practices to reduce the social security self-employment taxes that they pay. This section discusses several of the more important business and investment choices that can be affected by social security taxation. We show that tax-induced changes in business operations are often socially inefficient. The changes reduce the efficiency of farm operations and lead to a decline in gross (before-tax) farm income. Farmers benefit from the adjustments because tax savings exceed the decline in gross income, leaving a larger net (after-tax) income. Social welfare is reduced because farmers' net gains are less than the government's loss of tax revenue.

Our discussion of tax management applies primarily to those farmers who have wage and self-employment income that is less than maximum taxable social security earnings. At present, the first $37,800 of earnings are subject to the social security tax. Farmers who earn less than this amount can achieve some social security tax savings with small changes in their business operations. Those who earn much more than this figure would need to make substantial changes in their operations to achieve any tax savings, since the savings would not begin until taxable earnings were reduced below $37,800.

We restrict our study to those young and middle-aged farmers who expect to earn relatively low rates of return on social security tax contributions. To simplify our analyses of tax management practices, we assume that these farmers totally disregard the retirement benefits that they might receive as a result of the payment of additional self-employment taxes. Thus each dollar of self-employment tax savings is assumed to be worth one full dollar. To some, this may appear to be an unrealistic assumption, but it may represent only a mild departure from reality. As an example, consider a farmer who expects to receive a real internal rate of return of zero on social security tax contributions. For such a farmer, each dollar of tax contributions would be expected to generate one more dollar of retirement benefits. These benefits would have a present value that would depend upon the applicable discount rate, which would be the farmer's real rate of return on alternative investments, and the length of the discounting period, which would be the length of time between payment of taxes and receipt of benefits. If the discounting period were 30 years, and the discount rate were 4 percent, one real dollar of future

benefits would have a present value of only 31 cents. If the discount rate were 8 percent, the present value would be just 10 cents. This latter figure is not far from the zero present value assumed in our analysis.

Farm versus Nonfarm Investments

We first look at the problem of determining the amounts of a farmer's savings that should be allocated to farm versus nonfarm investments. We assume that there is a limit to the amount of capital that can be profitably employed in each farm operation. As the size of a farm approaches the limit, the proprietor begins making comparisons of the returns to farm and nonfarm investments. The social security tax can be an important factor in this comparison. The income from additional farm investments is subject to the tax when net farm profits are less than maximum taxable social security earnings. A farmer can avoid the tax by purchasing nonfarm investments such as stocks, bonds, or rental properties. The tax savings can more than offset the higher returns that might be earned by some farm investments.

Some information on the value of farm and nonfarm assets owned by farm proprietors was provided by the 1979 Farm Finance survey (18) conducted by the Bureau of the Census. Table 2 contains statistics that were developed from this survey. The table shows that farm production assets account for about 74 percent of the total value of all assets owned by farm proprietors. Financial assets, operator dwellings, and other nonfarm assets account for the remaining 26 percent. The income generated by the farm production assets is generally subject to both income and self-employment taxation. The income earned by the remaining assets is either implicit income which is totally tax-exempt (operator dwellings provide such income), or income that is subject to income taxation but not social security taxation.

In general, the social security tax reduces the returns to farm assets and thus creates a bias toward nonfarm investments. An exception is the case in which farm assets earn real positive returns but negative taxable returns. An example is a debt-financed investment in farmland. If interest expenses and property taxes exceed the income generated by farming the land, the owner's taxable net farm profit is reduced by the land purchase. The real after-tax return on the land includes the income tax savings and social security tax savings that result from the decline in taxable net profit. Thus the social security tax raises the after-tax return on the land. The total return includes the capital gain earned as inflation reduces the real value of the nominal land debt, and any gain from real land value appreciation. As the nominal value of the land increases, the owner may be able to refinance the debt to maintain large interest deductions, and thus continue to show a net loss that generates income and social security tax savings.

Some farm machinery investments can produce temporary income and social security tax savings. During the first several years of the service life of a machine, interest expenses and large tax depreciation deductions can exceed the additional income generated by the machine, and thus reduce taxable net farm profit, and produce tax savings. However, as the machine ages, the deductions fall more rapidly than the machine's gross income, and the machine begins to raise the farmer's taxable net farm profit and tax liability. In general, the tax liabilities generated by the machine in the latter years of its life will more than offset the tax savings from the early years. As a result, the after-tax rate of return on the machine is reduced by the social security tax. With the exception noted above (the debt-financed

Table 2--Assets owned by farm proprietors, 1980 1/

Asset type	Value	Percentage of total
	Million dollars	Percent
Farm production assets:		
Farmland	241,319	49.0
Farm structures	25,969	5.3
Farm machinery	54,493	11.1
Crops	9,889	2.0
Livestock	33,019	6.7
Financial assets:		
Cash and currency	457	.1
Checking and savings accounts	18,540	3.8
Money owed to operators	4,342	.9
Cash value of life insurance	5,663	1.2
Stocks, bonds, and CD's	21,419	4.4
Onfarm operator dwellings	47,119	9.6
Other nonfarm assets 2/	29,972	6.1
Total 3/	492,202	100.0

1/ Excludes farm partnerships, corporations, and other nonproprietorship forms of organization.

2/ Includes off-farm dwellings and other nonfarm assets such as cotton gins, stocks of cooperative organizations, motels, stores, vehicles, machinery, and equipment for nonfarm uses.

3/ Totals do not add due to rounding.

Source: (18, tables 17, 18, 19).

investment in land), the social security tax reduces the returns to farm investments and thus creates a bias toward nonfarm investments that earn income exempt from social security taxation.

Figure 1 shows how tax-induced nonfarm investments can produce a reduction in the optimal size of a farm proprietorship. It is assumed that the marginal rate of return on farm assets declines as the size of the farm is expanded. Nonfarm assets are assumed to earn a fixed rate of return. In the absence of taxes, the size of the farm would be expanded to the point where the marginal returns to farm and nonfarm assets were equal. This is shown by the intersection of the solid lines on the graph. The optimal-sized farm would contain farm capital worth b dollars. If the wealth of the farmer increased beyond this point, the additional wealth would be invested in nonfarm assets.

Since the income from both farm and nonfarm assets is subject to the income tax, but only farm investment income is subject to the social security tax, the returns to farm assets decline by a larger percentage when the two taxes are imposed. The dashed lines in figure 1 show that the social security tax reduces the optimal size of the farm operation to that which contains only a dollars of capital. When the wealth of the farmer increases beyond this point, the additional wealth is invested in nonfarm assets that yield higher after-tax returns. 11/

The tax-induced reduction in farm size produces a deadweight loss from misallocation of capital. The loss is measured by the shaded triangle in figure 1. The loss results from the fact that some nonfarm capital is earning a before-tax return that is less than the return that the capital would earn if it were employed in the farm.

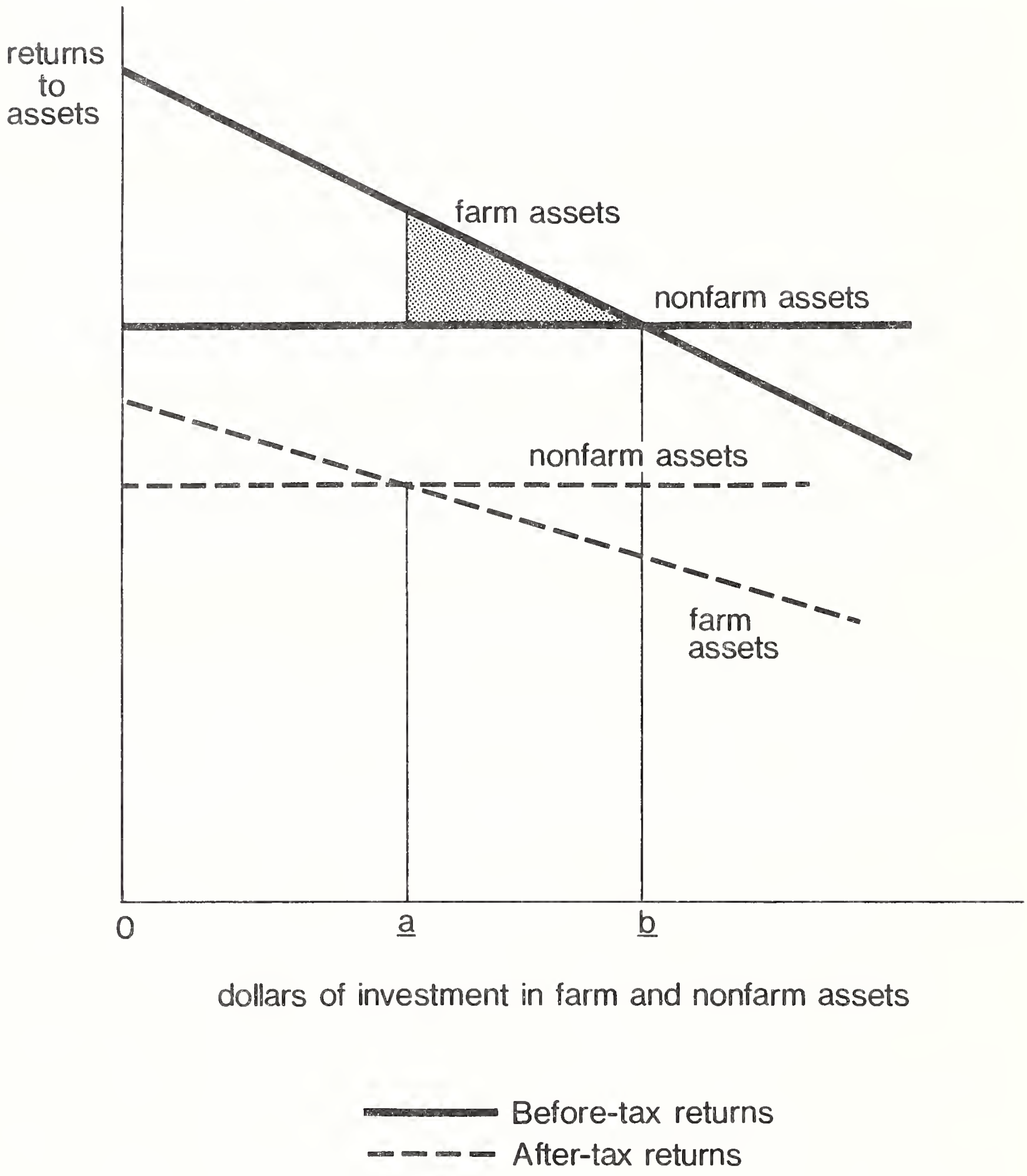
Debt Management

Interest on farm debt is reported on Schedule F and yields both income and social security tax savings. The after-tax cost of farm debt is reduced by the social security tax. The tax thus increases the incentive for farmers to borrow to expand their operations. The tax may have raised the average debt-to-equity ratio of farm proprietors. If so, any resulting increase in farm size would tend to offset the tendency toward smaller farm size that results from the tax bias toward nonfarm investments.

11/ This analysis is based on a comparison of statutory income tax rates. A more thorough analysis of the differences in the tax treatment of farm and nonfarm investments would require a comparison of effective tax rates for various types of investments. Statutory and effective income tax rates differ to the extent that true and taxable income are unequal. The effective tax rates for depreciable assets such as equipment and structures are generally less than corresponding statutory rates because investment tax credits and the acceleration of tax depreciation deductions more than offset the effects of inflation on the real value of nominal depreciation deductions. Effective tax rates for appreciating assets are generally less than statutory rates because long-term capital gains are taxed at reduced rates, and capital gains taxes are not levied until assets are sold. Effective tax rates for interest-bearing assets are greater than statutory rates during times of inflation because the income tax is levied on nominal rather than real interest income. For an examination of effective income tax rates for farm capital, see (8).

Figure 1

Tax-induced reduction in size of farm operation



Interest on personal or nonfarm debt is reported on Form 1040 and yields income tax savings but no social security tax savings. Thus, nonfarm debt has a higher after-tax cost than farm debt. Farmers have an incentive to use farm debt to finance personal investments and expenditures. To the extent that this is done, the financial risk of farm operations is increased. [See (6) for a definition of financial risk.] This greater risk is partly offset by a reduction in the financial risk of the personal investments that are financed with farm debt.

Farmland Rentals

The rental income earned by farm operator landlords is generally exempt from social security taxation. Some farm operators may therefore find it profitable to rent out land that they would otherwise employ in their farm operations. The tax savings may more than offset the higher gross income that might have been earned by farming rather than renting the land.

Figure 2 illustrates the effects of this tax reduction strategy on the optimal size of a farm proprietorship. It is assumed that the value of the marginal product of farmland declines as the proprietor attempts to farm more land with a fixed supply of labor and equipment. In the absence of taxes, the proprietor farms b acres of land and rents out any remaining land that might be owned. When the income and self-employment taxes are imposed, the returns to operated land decline by a larger percentage than the returns to land that is rented to others. The dashed lines show that the optimal size of the farm operation is reduced to a acres of farmland, with all remaining land being rented to others. There is a deadweight loss from this reduction in farm size because the additional rented land (b-a) earns a before-tax return that is less than the return that it would earn if it were employed in its owner's farm.

According to the 1978 census of agriculture, there were 276,312 farm operators who rented out farmland that they owned. 12/ At least 97 percent of these were farm proprietors or members of partnerships who would normally be subject to the self-employment tax. 13/ It is likely that some of these farmers reduced their self-employment taxes by renting out land that they would have otherwise employed in their farm operations. In some cases the self-employment tax savings may have been an important or determining factor in the decision to rent rather than farm the land.

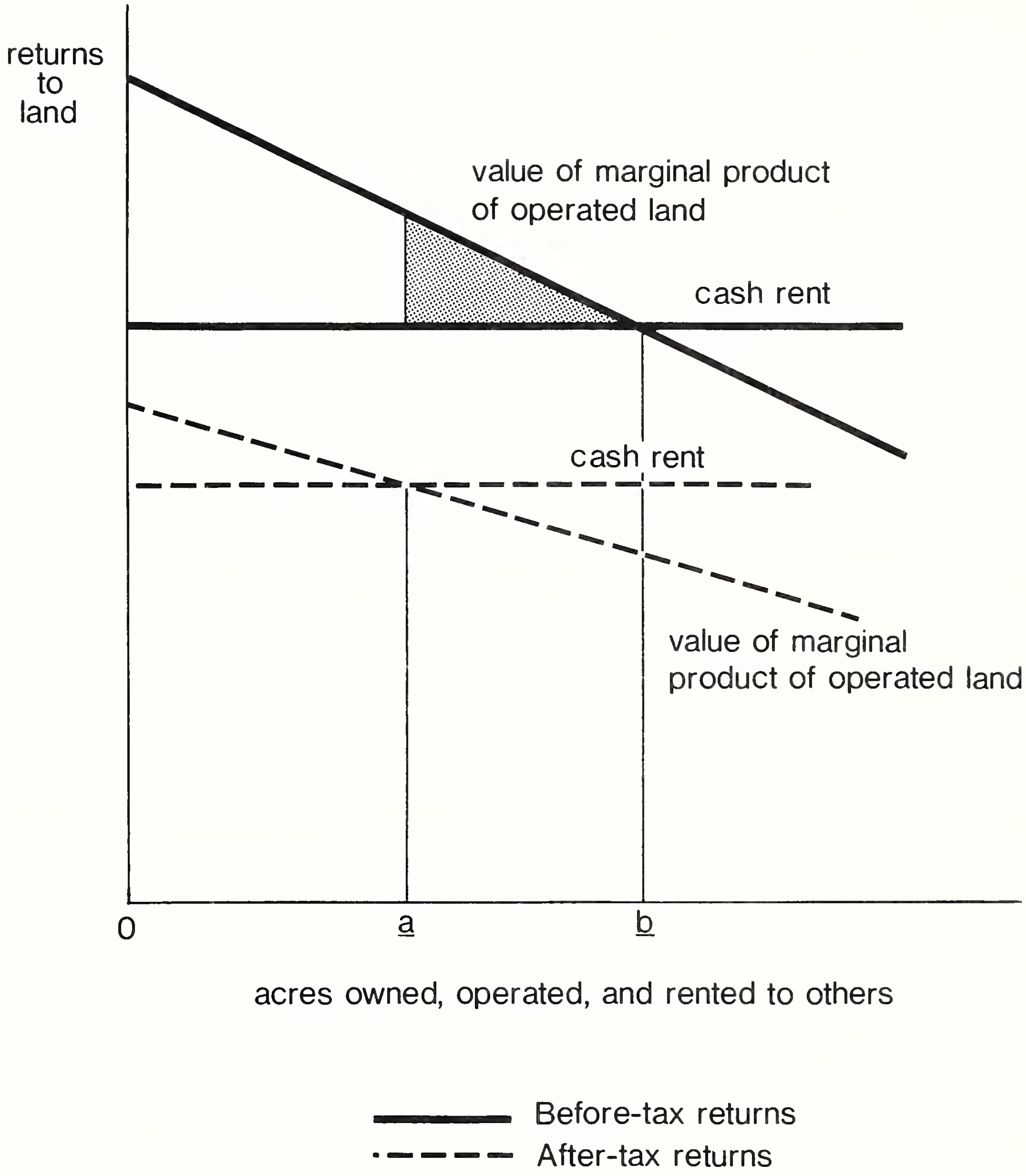
Farmers who rent out land to avoid self-employment taxes must carefully avoid material participation in the farm operations in which the land is used. If a landlord receives rent in the form of crop shares and participates in the management of the operation that uses the rented land, or provides the operation with financing, equipment, or labor, the landlord's rental income may be classified as income from self-employment, which would be subject to the self-employment tax. IRS and Social Security Administration regulations indicate that landlords can provide tenants with a limited amount of assistance without subjecting rental income to self-employment taxation. Landlords wishing to provide the maximum possible assistance while avoiding the tax may

12/ See (17, table 5, p. 124).

13/ This statement is based on the fact that there were 8,390 corporate farms that leased owned land or subleased rented land to others. See (17, table 30, p. 30).

Figure 2

Tax-induced reduction in size of farm operation



benefit from the use of written rental agreements that limit the extent of landlord participation.

There may now be a large number of situations in which a landlord's participation is being reduced or eliminated by the desire to avoid social security taxes. If it is assumed that participating landlords are providing their tenants with financing, equipment, labor, or managerial assistance that would be more costly for the tenants to obtain from other sources, it can be argued that tax-induced reductions in landlord participation are socially inefficient.

Renting out farmland can result in the underutilization of a farmer's equipment, labor, and managerial skills. A farmer may have difficulty in finding alternative uses for these resources. Some farmers may have minimized this problem by renting land from others to maintain the sizes of their farm operations while they continue to rent some owned land to others to reduce social security taxes. The following example illustrates the tax savings that can be produced by this cross-leasing of farmland.

Assume a farmer owns and farms 640 acres. Crop receipts are expected to be $170,000, with variable costs of production of $135,000, leaving net farm profits of $35,000. To reduce net farm profits and self-employment taxes, the farmer rents out 160 acres of land at $100 per acre, and rents from others the same amount and quality of land at the same price. Crop production and crop receipts are most likely unchanged, but the farmer's costs of production increase by the $16,000 of rent, so net farm profits decline to $19,000. The smaller profits are offset by the rental income from the 160 acres of land leased to others. Total income remains unchanged, but the farmer's social security tax payments decline. At the current (1984) tax rate of 11.3 percent, social security taxes drop from $3,955 to $2,147, a saving of more than $1,800.

Some information on the extent of cross-leasing of farmland was provided by the 1978 census of agriculture. The census defines "part owners" to be those who farm both owned land and rented land from others, and "tenants" to be those who farm only land rented from others. According to the 1978 census, there were 44,561 part owners and 8,546 tenants nationwide who owned some farmland that they had rented to others (17, pp. 126-27). Thus a total of more than 53,000 farmers were renting land to others while they were farming land that they had rented from others. About 97 percent of these farmers were unincorporated and were thus subject to the social security self-employment tax (17, pp. 22-23).

It is likely that almost all of these 53,000 farmers had legitimate non-tax reasons for this cross-leasing of land. Due to factors such as distance, type of land, or age or health of operator, it would not have been economically feasible for some of these operators to farm all of the land that they owned, and in some cases the leasing may have had no effect on self-employment tax liabilities. However, it is likely that many of the unincorporated farmers in this group would have had larger self-employment tax liabilities if they had not engaged in this cross-leasing. For some of these operators, the tax savings may have had an important or determining effect on their leasing decisions.

The deliberate cross-leasing of farmland for tax reduction purposes can result in an inefficient use of farmland. Those who farm rented land may have less incentive to use cropping practices that contribute to soil conservation. And some renters may be farming less efficiently due to their lack of specific

knowledge of how their rented land responds to differences in cropping practices, fertilizer application, and changes in weather. Landlords may have acquired this knowledge through prior farming of the land (11, p. 311). The tax savings from cross-leasing of farmland can more than offset these losses from increased soil erosion and reduced farming efficiency, but society receives no compensation for the losses, so the tax-induced cross-leasing of farmland can be socially inefficient.

Animal Husbandry

Gains from the sale of livestock that are raised for sale or purchased for resale are reported on Schedule F and are subject to the social security tax. However, gains from the sale of livestock that are used or held for draft, dairy, breeding, or sporting purposes are reported on Form 4797 and are exempt from social security taxation. When the livestock are held for at least 2 years (cattle and horses) or 1 year (other livestock) prior to sale, the gains also qualify as long-term capital gains and become eligible for a partial income tax exemption. The social security and income tax structures create incentives for farm operators to use livestock for the above-mentioned purposes and hold livestock for the required time periods to obtain the tax exemptions.

Swine

Davenport, Boehlje, and Martin (3, p. 27) argue that the income tax structure gives swine producers an incentive to hold all gilts through one farrowing to increase the proportion of hog sales that qualify for long-term capital gains treatment. The normal practice would be to use each breeding sow for a number of farrowings, and retain only0a small percentage of gilts for breeding, to replace those sows that were being sold. This practice would be more efficient than the breeding of each gilt because a sow's first litter is normally smaller than succeeding litters. Swine producers have an incentive to breed each gilt because the drop in gross income that results from this practice can be more than offset by the income tax savings from the capital gains tax treatment of all gilt sales.

The social security tax structure may be having the same effect on swine husbandry. When producers hold all gilts through one farrowing, and thus increase the proportion of hog sales that qualify for capital gains treatment, they reduce the amount of their income reported on Schedule F, and increase the amount that is reported on Form 4797 and Schedule D. The result is a decrease in the amount of income subject to social security taxation.

Research reported by Davenport, Boehlje, and Martin showed that the income tax savings from the breeding of all gilts are a function of the income tax bracket of the swine producer. The research indicated that breeding all gilts would be profitable for farrow-to-finish hog producers with average income tax rates above 39 percent, while those with lower tax rates would find it more profitable to hold each sow through four litters (3, pp. 38-40). If the social security tax were included in this analysis, the combined income and social security tax rate would be the deciding factor in choosing between the two breeding practices. Given the current self-employment tax rate of 11.3 percent, we estimate that breeding all gilts would be profitable for producers with average income tax rates greater than 28 percent. The break-even income tax rate will fall as the self-employment tax rate rises

over time. Thus a larger number of producers will have an incentive to use the inefficient practice of breeding all gilts.

Cattle

Krause and Shapiro (10) argue that the income tax structure gives ranchers an incentive to breed a higher fraction of raised heifers to increase the fraction of cattle sales that qualify for long-term capital gains tax treatment. The fraction of a rancher's total sales that qualify for capital gains treatment would be related to the average age of the cows in the rancher's herd, with a lower age being associated with more capital gains sales. Krause and Shapiro argue that ranchers in higher tax brackets have more of an incentive to obtain the capital gains tax treatment and thus should tend to have herds with a lower average cow age.

The social security tax may be reinforcing the effect of the income tax on cattle raising. Since sales of cows are reported on Form 4797 in lieu of Schedule F, the income from these sales is exempt from social security taxation. Ranchers can reduce their income and social security taxes by breeding a larger fraction of their heifers and selling their cows at earlier ages.

As more heifers are bred, more cows must be sold to maintain a stable herd size. In general, heifers have a lower rate of conception than cows, and also experience more calving problems. Thus the tax-induced breeding of heifers in lieu of cows can be an inefficient practice. The use of this practice would be limited to those ranchers who can earn income and social security tax savings that more than offset the losses associated with the breeding problems of the heifers.

Incorporation of the Farm Business

The incorporation of a farm proprietorship or partnership is one additional method by which some farm operators can reduce their social security tax liabilities. Incorporation affects both the income and social security tax treatment of farm profits. In many situations, the payments due under one or both of these taxes can be reduced by incorporation. Boehlje and Krause (2) analyzed the potential for tax savings under the 1979 tax structure. We present similar analyses using the current (1984) social security tax rates and those scheduled to become effective in 1990.

At present, the first $37,800 of an individual's wage and self-employment income are subject to social security taxation. Proprietorship and partnership income is self-employment income and is taxed at an effective rate of 11.3 percent. The owners of farm corporations pay themselves wages and salaries that are taxed at a total effective rate of 13.7 percent. Although this is higher than the tax rate on self-employment income, the owners of a farm corporation can reduce the amount of their income that is subject to social security taxation by reducing their wages and salaries and retaining (reinvesting) a portion of total earnings in the corporation. If a sufficient amount of earnings is retained, total social security tax liabilities can be less than those of a farm proprietor earning the same profits.

Incorporation affects income taxes as well as social security taxes when some profits are retained in the corporation. Retained earnings are subject to the corporate income tax but are exempt from personal income taxation. If some earnings are retained, incorporation will reduce the personal income tax liability of a farmer while creating a corporate tax liability. The net

effect on total liability will depend upon the marginal rates of the two taxes. The tax rate schedule for corporations is shown in table 3. At present, the first $25,000 of retained corporate earnings are taxed at a rate of 15 percent. If the last dollar of a proprietor's net farm profit is being taxed at a rate higher than 15 percent, incorporation can reduce the farmer's total income tax liability. Maximum income tax savings can be achieved by increasing retained earnings and reducing the salary paid to the farm firm's owner until the marginal corporate income tax rate is no longer less than the owner's marginal personal income tax rate.

Table 5 provides examples of the annual income and social security tax savings and losses that can result from the incorporation of a farm proprietorship under current law. It is assumed that the farmer has no off-farm income. Personal income tax liability is computed using the standard deduction, four exemptions, and the 1984 tax schedule for married couples filing joint returns, shown in table 4. The changes in tax liability are computed for incomes ranging from $20,000 to $50,000. The percentage of farm income retained (reinvested) in the newly formed corporation is assumed to range from zero to 50 percent.

The top portion of table 5 shows that the current social security tax structure discourages incorporation in a large number of cases. This results from the difference in tax rates: 11.3 percent for self-employment income, but 13.7 percent for wage and salary income. Those farm proprietors who incorporate and pay themselves $37,800 or more in wages and salary must pay an additional $907 in social security taxes. Tax savings are restricted to those who retain a large portion of farm profits in their corporations and thus offset the higher tax rate by reducing the amount of their income subject to the social security tax.

The middle portion of table 5 shows that the current income tax structure tends to encourage incorporation. A portion of the income tax savings results from the fact that the social security taxes paid by a corporation (for wages paid to its owner-employee) are not subject to either corporate or personal income taxation. Additional savings occur in those cases in which retained corporate earnings are being taxed at a rate that is less than the personal income tax rate that would apply to the earnings if they were paid to the owner-employee in the form of wages. When the differences in the marginal tax rates are large, the savings from this source can be substantial. The largest savings are found in those sections of the table where farm income is high and a large portion of earnings are retained in the corporation.

In the bottom portion of table 5, the income tax savings from incorporation are added to the social security tax savings (or loss) to obtain the total tax change. 14/ At most income levels, some earnings must be retained in order for incorporation to produce tax savings. Overall, it appears that the tax system encourages incorporation. Total tax savings increase as more earnings are retained.

14/ Incorporated farmers may be required to pay additional taxes for workers' compensation and unemployment insurance programs. The requirements vary by State. Boehlje and Krause say that participation in these programs is not mandatory for most family farms. They argue that the income and social security taxes are the key factors to consider in deciding whether to incorporate. Taxes for workers' compensation and unemployment insurance are not reflected in the totals shown in the bottom portions of tables 5 and 6. Krause (9) provides detailed information about these taxes.

Table 3--Tax rate schedule for corporations, 1984

Taxable income	Tax rate
Dollars	Percent
0 - 25,000	15
25,000 - 50,000	18
50,000 - 75,000	30
75,000 - 100,000	40
100,000 and over	46

Table 4--Tax rate schedule for married couples filing joint returns, 1984

Taxable income	Tax rate
Dollars	Percent
0 - 3,400	0
3,400 - 5,500	11
5,500 - 7,600	12
7,600 - 11,900	14
11,900 - 16,000	16
16,000 - 20,200	18
20,200 - 24,600	22
24,600 - 29,900	25
29,900 - 35,200	28
35,200 - 45,800	33
45,800 - 60,000	38
60,000 - 85,600	42
85,600 - 109,400	45
109,400 - 162,400	49
162,400 and over	50

Table 5-- Tax savings from incorporation, 1984

Annual farm income in dollars	Percentage of income reinvested: 0	10	20	30	40	50
	Social security tax savings					
	Dollars					
20,000	-301	-45	211	467	724	980
30,000	-451	-67	317	701	1,085	1,469
40,000	-877	-338	174	686	1,199	1,711
50,000	-907	-907	-850	-210	430	1,070
	Income tax savings					
	Dollars					
20,000	182	181	162	123	77	0
30,000	474	641	737	784	782	743
40,000	781	1,212	1,546	1,808	1,958	2,006
50,000	883	1,783	2,583	3,105	3,507	3,751
	Total tax savings					
	Dollars					
20,000	-119	136	373	590	801	980
30,000	23	574	1,054	1,[illegible]5	1,867	2,212
40,000	-96	874	1,720	2,494	3,157	3,717
50,000	-24	876	1,733	2,895	3,937	4,821

Table 6-- Tax savings from incorporation, 1990

Annual farm income in dollars	Percentage of income reinvested					
	0	10	20	30	40	50
	Social security tax savings					
	Dollars					
20,000	-17	268	552	836	1,120	1,405
30,000	-25	401	828	1,254	1,681	2,107
40,000	-33	535	1,104	1,672	2,241	2,809
50,000	0	0	99	809	1,520	2,231
	Income tax savings					
	Dollars					
20,000	1	-1	-25	-65	-114	-193
30,000	3	166	253	294	290	246
40,000	5	431	760	1,012	1,153	1,193
50,000	0	900	1,682	2,191	2,580	2,813
	Total tax savings					
	Dollars					
20,000	-16	267	527	771	1,006	1,212
30,000	-22	567	1,081	1,548	1,971	2,353
40,000	-28	966	1,864	2,684	3,394	4,002
50,000	0	900	1,781	3,000	4,100	5,044

Effects of the tax system on incentives for incorporation will change over time as social security tax rates are increased. When the last of the scheduled increases becomes effective in 1990, the tax rates for wage and self-employment income will become equal at 15.3 percent, and other adjustments will be made to equalize the social security tax treatment of the two types of income. Table 6 shows the social security and income tax savings and losses that would result from incorporation if these changes scheduled for 1990 were made effective this year.

A comparison of the top portions of tables 5 and 6 shows that the 1990 tax structure will provide greater tax savings (or smaller losses) for those who incorporate. With the equalization of the tax rates for wage and self-employment income, there will no longer be a large social security tax penalty paid by those incorporated farmers who distribute all farm profits to themselves in the form of wages. These incorporated farmers will pay about the same in social security taxes as farm proprietors who earn the same income, and they will have the option of retaining some earnings in their corporations to reduce the amount of their income subject to social security taxation. The top portion of table 6 shows that the social security tax savings from retention of earnings will be substantial.

Although the social security tax savings from incorporation will be increased by the 1990 tax structure, the income tax savings will be reduced. Self-employed workers will be given a personal income tax deduction equal to half of the self-employment taxes that they pay. This will offset the current income tax savings from incorporation that result from the fact that incorporated farmers do not pay personal income taxes on the share of social security taxes paid by their corporations for wages that they receive. A comparison of the middle portions of tables 5 and 6 shows that the income tax savings from incorporation will be lower in all situations.

On balance, the 1990 tax structure will provide somewhat greater incentives for incorporation. A comparison of the bottom portions of tables 5 and 6 shows that the 1990 total tax savings are larger in almost all cases. For those who retain a large portion of earnings in their firms, the total savings from incorporation are several hundred dollars larger.

There are some non-tax costs and benefits that should be considered by those deciding whether to incorporate. Aside from the expenditure required to obtain a State charter, the largest cost of incorporation may be the additional time that some farm operators need to spend to maintain the detailed records required of corporations. Boehlje and Krause argue that these detailed records could be a useful aid to business management (2, p. 7). They also argue that the time spent on maintaining these records could often be more profitably employed in planning the timing of input purchases and product sales and in making improvements in crop-growing practices (2, p. iv).

There can be a loss of farm efficiency or productivity if the bookkeeping requirements associated with incorporation produce a significant reduction in the time available for other farming activities. Incorporation remains worthwhile for those farmers who can realize tax savings that more than offset any loss of efficiency. However, society receives no compensation for losses produced by the reallocation of time from farming to bookkeeping, so tax-induced incorporations of farm businesses can be socially inefficient.

PROPOSALS FOR TAX REFORM

The social security tax structure is not neutral in its treatment of the investment income earned by farmers and other self-employed workers. These workers pay social security taxes on the income earned by their business capital, but the tax does not apply to income earned by their personal and nonbusiness investments. In the preceding section of this paper, it was shown that this non-neutral tax treatment creates incentives for self-employed farmers to adopt a number of inefficient business practices that have the effect of reducing social security tax liabilities. Self-employed workers in the nonfarm sectors of the economy can use some of the same business practices to reduce their social security taxes.

The potential for widespread use of these inefficient business practices merits consideration of tax reform to eliminate the tax savings which encourage their use. The required tax reform would be a change in the social security tax structure to provide for equal tax treatment of all of the investment income of self-employed workers. The neutrality could be achieved by either of two methods: the current taxation of the income earned by the business capital of self-employed workers could be eliminated to make all investment income exempt from the tax; or the income from all of the investments of all workers could be made subject to social security taxation.

Tax Exemption for Investment Income

It would not be difficult to provide a theoretical justification for a social security tax exemption for all investment income. The apparent aim of the social security system has been to provide a means of forced saving and insurance that provides for automatic replacement of the labor income lost at the time of a worker's retirement, death, or disability. In general, these events do not result in the loss of the business capital of self-employed workers, or the income earned by their capital. When the self-employed cease working, their business capital can be rented, or it can be sold and the proceeds reinvested elsewhere. Thus one can question the need for the social security coverage and taxation of this income to insure against its loss.

The income earned by the business capital of self-employed workers was originally made subject to social security taxation because there was thought to be no reliable method of separating the labor and capital income of these workers (16). As compensation for the taxation of income from capital, and for other reasons, the social security tax rate for the self-employed was originally fixed at three-fourths of the total rate for wage (and salary) workers and their employers. The tax rates for wage and self-employed workers are now scheduled to become equal in 1990. One could argue that these equal tax rates should be accompanied by equal tax bases to provide equitable treatment for the two groups of workers. If equal tax bases are an objective, we should reexamine the feasibility of exempting from taxation the investment income of self-employed workers.

Tax Deduction

The most straightforward method of excluding investment income from taxation would involve a tax deduction for such income to remove it from the tax base. The American Farm Bureau Federation (AFBF) (1) proposed such a deduction in a recent policy statement:

"We urge correction of the inequity in the method of determining earnings of self-employed persons subject to Social Security taxes when substantial portions of these earnings are related to a return on their investment in business property. A rent equivalent should be made an allowable deduction from earnings for this purpose."

The federation has not proposed any specific method for computing the value of these "rent equivalent" deductions. Any such method would need to be simple to facilitate tax compliance, and accurate to ensure that the social security tax base of each self-employed worker closely approximates the labor component of the worker's business income.

One method of estimating the income earned by the capital in unincorporated businesses would be the use of market rents for similar capital. Some types of capital have active rental markets that make it feasible to collect reliable data on rents. Farmland is a good example. The USDA publishes annual estimates of average cash rental rates for various types of farmland in about half of the 50 States. The survey which collects this data could be expanded and improved to increase coverage, reliability, and detail. Accurate estimates of rental rates should closely approximate the net income being earned by owner-operated farmland.

A different method would need to be used to estimate the income earned by assets that have no active rental markets. One approach would be to estimate the market values of these assets and the rates of return that these assets could be expected to earn. The product of value and rate of return would provide an estimate of annual income. The value of depreciable assets such as machinery and structures could be estimated as a function of initial purchase price and remaining service life, with adjustments for changes over time in the average prices of these types of capital. The market value of land could be estimated by adjusting initial purchase price from changes in average land prices. (USDA publishes annual price indexes for farmland that could be used for this purpose.) The average rates of return on land and depreciable assets could be estimated using aggregate industry data. As an example, USDA uses farm sector data to compute annual estimates of the rate of return on farm production assets.

Regardless of the methods used to estimate the income or rental value of capital, a procedure would need to be developed for using the estimates to compute the social security tax base of self-employed workers. The AFBF policy statement seems to suggest that the rental value of capital should be deducted from net farm profit (Schedule F) or net business profit (Schedule C) to obtain the social security tax base. This approach seems logical, but it would normally yield a tax base that is less than the labor share of business income. The underestimation would result from the capital-related tax deductions used in computing net profit. These deductions include tax depreciation, expenditures for repairs and maintenance of capital, interest on capital-secured debt, and property taxes. Costs of depreciation, repairs, interest, and property taxes would normally be borne by lessors of capital, and gross market rents would normally be high enough to cover these costs and provide lessors with a return on equity. There would be a double counting of these costs if self-employed workers were permitted to deduct these costs in computing net profit, and also deduct the gross rental value of capital to obtain the social security tax base.

Self-Renting of Capital

There is a simple procedure for computing the social security tax base that would avoid this problem of the double counting of the ownership costs of capital. To restrict the tax base to labor income, self-employed workers could be allowed to "rent" their business capital to themselves. The rents could be listed as a business expense on Schedule F (farmer) or Schedule C (nonfarmer) as appropriate. Gross rental income and associated interest expenses, property taxes, and tax depreciation deductions could be listed on Schedule E, as they would if the taxpayer were actually renting out the capital. Net rental income could be computed on Schedule E and transferred to Form 1040. If this were done, the rental income would be subject to Federal income taxation but exempt from social security taxation. The net business profits remaining on Schedules F or C would be limited to the labor income of the self-employed worker, and the social security tax base would also be limited to labor income.

If self-employed workers were permitted to rent capital to themselves for social security tax purposes, it would be necessary for the Treasury to set guidelines on the rental rates that could be used. Workers attempting to minimize their social security taxes would have an incentive to charge themselves high rents to reduce the portion of their business profits subject to the tax. The Treasury could use actual market rents or estimates of capital values and rates of return (as discussed above) to set maximum limits on the rents that could be used.

If the Treasury's limits on the rental rates that could be used for social security tax purposes were set too low, some of the investment income of self-employed workers would remain subject to taxation. This might result in the continued use of the tax avoidance methods discussed earlier in this paper that involve the use of inefficient business practices. If the Treasury limits on rental rates were set too high, the result would be the tax sheltering of some of the labor income of self-employed workers. This could encourage the use of a new set of tax-saving but inefficient business practices.

Expensing of Investments

The expensing of investments is an alternative method of excluding from social security taxation the income earned by the business capital of self-employed workers. Expensing is the allowance of a first-year tax deduction equal to the full purchase price of capital. Arnold Harberger (7) has shown that expensing reduces the effective rate of taxation of income from capital to zero.

If the tax rate is t, expensing provides an investor with first-year tax savings equal to the fraction t of the cost of investment. In effect, the Government pays the fraction t of the asset's cost. Through taxation, the Government also receives the fraction t of the current and future income that is earned by the asset. Since the Government shares equally in the costs and returns to the asset, the investor pays no tax on his or her share of the investment.

Expensing has normally been discussed as an alternative to the current permissible patterns of tax deductions for depreciable assets such as machinery, equipment, and structures. Although land and inventories are not depreciable assets, they can also be expensed to reduce their effective tax rates to zero.

If all investments were expensed on Schedules F and C, the effective income and social security tax rates for these investments would be reduced to zero. To retain the Federal income taxation of the income earned by these investments, while eliminating the social security taxation of such income, it would be necessary to modify Schedules F, C, and SE to allow for expensing of investments in computing self-employment earnings while retaining the current patterns of tax depreciation deductions for use in computing Form 1040 income. Expensing for Schedule SE would reduce the effective social security tax rate to zero while retaining the existing effective income tax rate.

One major difficulty with the expensing option is that which arises as a result of the limit on the amount of income subject to the social security tax. If the labor income earned by a self-employed worker is less than maximum taxable social security earnings, then some of the income attributable to capital will be taxed. However, the expensing of investments will produce tax savings only to the extent that it reduces total business earnings below maximum taxable earnings. When earnings after expensing are above maximum taxable earnings, there are no tax savings resulting from the expensing, but some income from investments remains taxable. In this case, the effective social security tax rate can be well above zero.

Change in Tax Base

An alternative solution to the problem of the non-neutral taxation of income from investments would be a change in the social security tax base from income to consumption. Under a consumption tax, all labor and investment income would be subject to social security taxation to the extent that the income was used for consumption. A tax exemption would be provided for income placed or retained in qualified investment accounts. All wage and self-employed workers would receive identical tax treatment.

A consumption-based social security tax would eliminate the need to separate the business income of self-employed workers into its labor and capital components. Both labor and capital income would be subject to the same tax treatment. Self-employed workers would no longer have an incentive to adopt the inefficient business and investment practices that now enable them to reduce the amount of their investment income subject to social security taxation.

Earlier it was argued that that there is no justification for the social security taxation of income from investments if the objective of the social security system is to replace a portion of the income lost when a worker retires, dies, or becomes disabled. A consumption-based tax would fall on the share of investment income used for consumption. This taxation of investment income could be justified if the objective of the social security system were broadened. The wider objective could include that of preventing any sharp drop in standard of living in the latter years of a worker's life. Standard of living can fall as a result of the loss of labor income or the loss of savings and investments and the income that they provide. Individuals can lose their savings and investments through misfortune (which could result from or be compounded by excessive risk taking), or by selling investments and drawing upon savings to finance consumption.

The social security system now forces covered workers to save a portion of their labor earnings for retirement. The amount of forced saving is directly

related to the worker's labor income. A consumption-based tax would make the savings directly related to consumption, which could be a better indicator of the amount of saving needed to prevent a sharp drop in standard of living in the latter years of a worker's life.

A Treasury publication (19) discusses the advantages and disadvantages of replacing the Federal income tax with a consumption tax. It argues that "a consumption base is superior to an income base as a measure of lifetime ability to pay" (19, p. 39). It also argues that a consumption tax would improve economic efficiency by eliminating many of the distortions of business and investment behavior that result from the tax incentives contained in the current income tax structure.

Conclusion

The social security tax structure provides farmers and other self-employed workers with incentives for making a number of tax-saving adjustments in their business operations and investments. These tax-saving adjustments can lead to a misuse or misallocation of resources and a resulting loss of economic efficiency. Most opportunities for tax savings are the result of the non-neautral tax treatment of the income earned by the personal and business investments of self-employed workers. These workers pay social security taxes on the income earned by their business capital, but the tax does not apply to income earned by their personal and nonbusiness investments. If the tax treatment of business and personal investments were made neutral, the existing tax incentives for many inefficient adjustments in business operations and investments would be eliminated.

The social security tax structure could be neutralized by eliminating the current taxation of the income earned by the business capital of self-employed workers. This could be accomplished by estimating the share of net business income attributable to business capital as opposed to labor, and providing a tax exemption for this capital income. There are several methods of dividing net business income into its labor and capital shares. It is not clear whether any of the methods would have the feasibility or reliability required for their use in the social security tax structure. A tax exemption for income from capital would not improve the neutrality of the social security tax structure if the estimates of the income were significantly biased or unreliable.

An alternative method of neutralizing the social security tax structure would be a change in the social security tax base from income to consumption. A consumption-based tax would be neutral among all personal and business investments and would thus restore incentives for the use of efficient business and investment practices.

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Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 1983 (0)

For the year January 1-December 31, 1983, or other tax year beginning , 1983, ending , 19 . OMB No. 1545-0074

Use IRS label. Otherwise, please print or type.

Your first name and initial (if joint return, also give spouse's name and initial)	Last name	**Your social security number**
Present home address (Number and street, including apartment number, or rural route)		**Spouse's social security number**
City, town or post office, State, and ZIP code	Your occupation	
	Spouse's occupation	

Presidential Election Campaign ▶ Do you want $1 to go to this fund? . . . . Yes No
If joint return, does your spouse want $1 to go to this fund? Yes No
Note: *Checking "Yes" will not increase your tax or reduce your refund.*

For Privacy Act and Paperwork Reduction Act Notice, see Instructions.

Filing Status

Check only one box.

1. Single
2. Married filing joint return (even if only one had income)
3. Married filing separate return. Enter spouse's social security no. above and full name here.
4. Head of household (with qualifying person). (See page 6 of Instructions.) If the qualifying person is your unmarried child but not your dependent, write child's name here.
5. Qualifying widow(er) with dependent child (Year spouse died ▶ 19). (See page 6 of Instructions.)

Exemptions

Always check the box labeled Yourself. Check other boxes if they apply.

6a Yourself — 65 or over — Blind
b Spouse — 65 or over — Blind
Enter number of boxes checked on 6a and b ▶

c First names of your dependent children who lived with you
Enter number of children listed on 6c ▶

d Other dependents:

(1) Name	(2) Relationship	(3) Number of months lived in your home	(4) Did dependent have income of $1,000 or more?	(5) Did you provide more than one-half of dependent's support?

Enter number of other dependents ▶

e Total number of exemptions claimed . . . . Add numbers entered in boxes above ▶

Income

Please attach Copy B of your Forms W-2, W-2G, and W-2P here.

If you do not have a W-2, see page 5 of Instructions.

Please attach check or money order here.

7 Wages, salaries, tips, etc. 7
8 Interest income *(also attach Schedule B if over $400 or you have any All-Savers interest)* . . . 8
9a Dividends *(also attach Schedule B if over $400)* , 9b Exclusion
c Subtract line 9b from line 9a and enter the result 9c
10 Refunds of State and local income taxes, from worksheet on page 10 of Instructions *(do not enter an amount unless you deducted those taxes in an earlier year—see page 10 of Instructions)* 10
11 Alimony received 11
12 Business income or (loss) *(attach Schedule C)* . . . . ▶ 12
13 Capital gain or (loss) *(attach Schedule D)* 13
14 40% capital gain distributions not reported on line 13 (See page 10 of Instructions) 14
15 Supplemental gains or (losses) *(attach Form 4797)* 15
16 Fully taxable pensions, IRA distributions, and annuities not reported on line 17 16
17a Other pensions and annuities, including rollovers. Total received 17a
b Taxable amount, if any, from worksheet on page 10 of Instructions 17b
18 Rents, royalties, partnerships, estates, trusts, etc. *(attach Schedule E)* 18
19 Farm income or (loss) *(attach Schedule F)* . . . . ▶ 19
20a Unemployment compensation (insurance). Total received . . . 20a
b Taxable amount, if any, from worksheet on page 11 of Instructions 20b
21 Other income (state nature and source—see page 11 of Instructions) 21
22 **Total income.** Add amounts in column for lines 7 through 21 . . . . ▶ 22

Adjustments to Income

(See Instructions on page 11)

23 Moving expense *(attach Form 3903 or 3903F)* 23
24 Employee business expenses *(attach Form 2106)* 24
25a IRA deduction, from the worksheet on page 12 . . . . 25a
b Enter here IRA payments you made in 1984 that are included in line 25a above ▶
26 Payments to a Keogh *(H.R. 10)* retirement plan 26
27 Penalty on early withdrawal of savings 27
28 Alimony paid 28
29 Deduction for a married couple when both work *(attach Schedule W)* 29
30 Disability income exclusion *(attach Form 2440)* 30
31 **Total adjustments.** Add lines 23 through 30 . . . . ▶ 31

Adjusted Gross Income

32 **Adjusted gross income.** Subtract line 31 from line 22. *If this line is less than $10,000, see "Earned Income Credit" (line 59) on page 16 of Instructions. If you want IRS to figure your tax, see page 3 of Instructions* . . . . ▶ 32

Tax Computation (See Instructions on page 13)	33	Amount from line 32 (adjusted gross income)	33	
	34a	If you itemize, complete Schedule A (Form 1040) and enter the amount from Schedule A, line 28	34a	
		Caution: If you have unearned income and can be claimed as a dependent on your parent's return, check here ▶ ☐ and see page 13 of the Instructions. Also see page 13 of the Instructions if: • You are married filing a separate return and your spouse itemizes deductions, OR • You file Form 4563, OR • You are a dual-status alien.		
	34b	If you do not itemize deductions on Schedule A (Form 1040), complete the worksheet on page 14. Then enter the allowable part of your charitable contributions here	34b	
	35	Subtract line 34a or 34b, whichever applies, from line 33	35	
	36	Multiply $1,000 by the total number of exemptions claimed on Form 1040, line 6e	36	
	37	Taxable Income. Subtract line 36 from line 35	37	
	38	Tax. Enter tax here and check if from ☐ Tax Table, ☐ Tax Rate Schedule X, Y, or Z, or ☐ Schedule G	38	
	39	Additional Taxes. (See page 14 of Instructions.) Enter here and check if from ☐ Form 4970, ☐ Form 4972, ☐ Form 5544, or ☐ section 72 penalty taxes	39	
	40	**Total.** Add lines 38 and 39 ▶	40	
Credits (See Instructions on page 14)	41	Credit for the elderly *(attach Schedules R&RP)*	41	
	42	Foreign tax credit *(attach Form 1116)*	42	
	43	Investment credit *(attach Form 3468)*	43	
	44	Partial credit for political contributions	44	
	45	Credit for child and dependent care expenses *(attach Form 2441)*	45	
	46	Jobs credit *(attach Form 5884)*	46	
	47	Residential energy credit *(attach Form 5695)*	47	
	48	**Total credits.** Add lines 41 through 47	48	
	49	**Balance.** Subtract line 48 from line 40 and enter difference (but not less than zero) ▶	49	
Other Taxes (Including Advance EIC Payments)	50	Self-employment tax *(attach Schedule SE)*	50	
	51	Alternative minimum tax *(attach Form 6251)*	51	
	52	Tax from recapture of investment credit *(attach Form 4255)*	52	
	53	Social security tax on tip income not reported to employer *(attach Form 4137)*	53	
	54	Uncollected employee social security tax and RRTA tax on tips *(from Form W-2)*	54	
	55	Tax on an IRA *(attach Form 5329)*	55	
06	56	**Total tax.** Add lines 49 through 55 ▶	56	
Payments Attach Forms W-2, W-2G, and W-2P to front.	57	Federal income tax withheld	57	
	58	1983 estimated tax payments and amount applied from 1982 return	58	
	59	Earned income credit. If line 33 is under $10,000, see page 16	59	
	60	Amount paid with Form 4868	60	
	61	Excess social security tax and RRTA tax withheld (two or more employers)	61	
	62	Credit for Federal tax on special fuels and oils *(attach Form 4136)*	62	
	63	Regulated Investment Company credit *(attach Form 2439)*	63	
	64	**Total payments.** Add lines 57 through 63 ▶	64	
Refund or Amount You Owe	65	If line 64 is larger than line 56, enter amount **OVERPAID** ▶	65	
	66	Amount of line 65 to be **REFUNDED TO YOU** ▶	66	
	67	Amount of line 65 to be applied to your 1984 estimated tax ▶	67	
	68	If line 56 is larger than line 64, enter **AMOUNT YOU OWE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number and "1983 Form 1040" on it ▶ (Check ▶ ☐ if Form 2210 (2210F) is attached See page 17 of Instructions.) $	68	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge

▶ Your signature | Date | ▶ Spouse's signature (if filing jointly, BOTH must sign)

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's social security no.
Firm's name (or yours, if self-employed) and address ▶		E.I. No.	
		ZIP code	

SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service (0)

Profit or (Loss) From Business or Profession

(Sole Proprietorship)

Partnerships, Joint Ventures, etc., Must File Form 1065.

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

1983

09

Name of proprietor | Social security number of proprietor

A Main business activity (see Instructions) ▶ ; product ▶

B Business name and address ▶

C Employer identification number

D Method(s) used to value closing inventory:

(1) ☐ Cost (2) ☐ Lower of cost or market (3) ☐ Other (attach explanation)

E Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

	Yes	No
F Was there any major change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation.		
G Did you deduct expenses for an office in your home?		

PART I.—Income

1 a Gross receipts or sales	1a	
b Less: Returns and allowances	1b	
c Subtract line 1b from line 1a and enter the balance here	1c	
2 Cost of goods sold and/or operations (Part III, line 8)	2	
3 Subtract line 2 from line 1c and enter the **gross profit** here	3	
4 a Windfall Profit Tax Credit or Refund received in 1983 (see Instructions)	4a	
b Other income	4b	
5 Add lines 3, 4a, and 4b. This is the **gross income** ▶	5	

PART II.—Deductions

6 Advertising		23 Repairs	
7 Bad debts from sales or services (Cash method taxpayers, see Instructions)		24 Supplies (not included in Part III)	
8 Bank service charges		25 Taxes (Do not include Windfall Profit Tax here. See line 29.)	
9 Car and truck expenses		26 Travel and entertainment	
10 Commissions		27 Utilities and telephone	
11 Depletion		28 a Wages	
12 Depreciation and Section 179 deduction from Form 4562 (not included in Part III)		b Jobs credit	
		c Subtract line 28b from 28a	
		29 Windfall Profit Tax withheld in 1983	
13 Dues and publications		30 Other expenses (specify):	
14 Employee benefit programs		a	
15 Freight (not included in Part III)		b	
16 Insurance		c	
17 Interest on business indebtedness		d	
18 Laundry and cleaning		e	
19 Legal and professional services		f	
20 Office expense		g	
21 Pension and profit-sharing plans		h	
22 Rent on business property		i	

31 Add amounts in columns for lines 6 through 30i. These are the **total deductions** ▶	31	
32 Net profit or (loss). Subtract line 31 from line 5 and enter the result. If a profit, enter on Form 1040, line 12, and on Schedule SE, Part I, line 2 (or Form 1041, line 6). If a loss, go on to line 33	32	

33 If you have a loss, you must answer this question: "Do you have amounts for which you are not at risk in this business (see Instructions)?" ☐ Yes ☐ No
If "Yes," you must attach Form 6198. If "No," enter the loss on Form 1040, line 12, and on Schedule SE, Part I, line 2 (or Form 1041, line 6).

PART III.—Cost of Goods Sold and/or Operations (See Schedule C Instructions for Part III)

1 Inventory at beginning of year (if different from last year's closing inventory, attach explanation)	1	
2 Purchases less cost of items withdrawn for personal use	2	
3 Cost of labor (do not include salary paid to yourself)	3	
4 Materials and supplies	4	
5 Other costs	5	
6 Add lines 1 through 5	6	
7 Less: Inventory at end of year	7	
8 **Cost of goods sold and/or operations.** Subtract line 7 from line 6. Enter here and in Part I, line 2, above.	8	

For Paperwork Reduction Act Notice, see Form 1040 Instructions. **Schedule C (Form 1040) 1983**

SCHEDULE D (FORM 1040)

Department of the Treasury
Internal Revenue Service (0)

Capital Gains and Losses

(Examples of property to be reported on this Schedule are gains and losses on stocks, bonds, and similar investments, and gains (but not losses) on personal assets such as a home or jewelry.)

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).

OMB No. 1545-0074

1983

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Name(s) as shown on Form 1040 | Your social security number

PART I.—Short-term Capital Gains and Losses—Assets Held One Year or Less

a. Description of property (Example, 100 shares 7% preferred of "Z" Co.)	b. Date acquired (Mo., day, yr.)	c. Date sold (Mo., day, yr.)	d. Gross sales price	e. Cost or other basis, plus expense of sale	f. LOSS If column (e) is more than (d) subtract (d) from (e)	g. GAIN If column (d) is more than (e) subtract (e) from (d)
1						

2 Short-term gain from sale or exchange of a principal residence from Form 2119, lines 7 or 11	2		
3 Short-term capital gain from installment sales from Form 6252, line 21 or 29	3		
4 Net short-term gain or (loss) from partnerships, S corporations, and fiduciaries	4		
5 Add lines 1 through 4 in column f and column g	5	( )	
6 Combine columns f and g of line 5 and enter the net gain or (loss)		6	
7 Short-term capital loss carryover from years beginning after 1969		7	( )
8 Net short-term gain or (loss), combine lines 6 and 7		8	

PART II.— Long-term Capital Gains and Losses—Assets Held More Than One Year

a.	b.	c.	d.	e.	f.	g.
9						

10 Long-term gain from sale or exchange of a principal residence from Form 2119, lines 7, 11, 16 or 18	10		
11 Long-term capital gain from installment sales from Form 6252, line 21 or 29	11		
12 Net long-term gain or (loss) from partnerships, S corporations, and fiduciaries	12		
13 Add lines 9 through 12 in column f and column g	13	( )	
14 Combine columns f and g of line 13 and enter the net gain or (loss)		14	
15 Capital gain distributions		15	
16 Enter gain from Form 4797, line 6(a)(1)		16	
17 Combine lines 14 through 16		17	
18 Long-term capital loss carryover from years beginning after 1969		18	( )
19 Net long-term gain or (loss), combine lines 17 and 18		19	

Note: *Complete the back of this form. However, if you have capital loss carryovers from years beginning before 1970, do not complete Parts III or V. See Form 4798 instead.*

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

PART III.—Summary of Parts I and II

20 Combine lines 8 and 19, and enter the net gain or (loss) here	20	
Note: *If line 20 is a loss, skip lines 21 through 23 and complete lines 24 and 25. If line 20 is a gain complete lines 21 through 23 and skip lines 24 and 25.*		
21 If line 20 shows a gain, enter the smaller of line 19 or line 20. Enter zero if there is a loss or no entry on line 19 — 21		
22 Enter 60% of line 21	22	
If line 22 is more than zero, you may be liable for the alternative minimum tax. See Form 6251.		
23 Subtract line 22 from line 20. Enter here and on Form 1040, line 13	23	
24 If line 20 shows a loss, enter one of the following amounts: a If line 8 is zero or a net gain, enter 50% of line 20; b If line 19 is zero or a net gain, enter line 20; or c If line 8 and line 19 are net losses, enter amount on line 8 added to 50% of the amount on line 19	24	
25 Enter here and as a loss on Form 1040, line 13, the smallest of: a The amount on line 24; b $3,000 ($1,500 if married and filing a separate return); or c Taxable income, as adjusted	25	

PART IV.—Complete this Part Only If You Elect Out of the Installment Method And Report a Note or Other Obligation at Less Than Full Face Value

☐ Check here if you elect out of the installment method.

Enter the face amount of the note or other obligation ▶ ....

Enter the percentage of valuation of the note or other obligation ▶

PART V.—Computation of Post-1969 Capital Loss Carryovers from 1983 to 1984

(Complete this part if the loss on line 24 is more than the loss on line 25)

Note: *You do not have to complete Part V on the copy you file with IRS.*

Section A.—Short-term Capital Loss Carryover

26 Enter loss shown on line 8; if none, enter zero and skip lines 27 through 30 then go to line 31.	26	
27 Enter gain shown on line 19. If that line is blank or shows a loss, enter zero	27	
28 Reduce any loss on line 26 to the extent of any gain on line 27	28	
29 Enter smaller of line 25 or line 28	29	
30 Subtract line 29 from line 28. This is your short-term capital loss carryover from 1983 to 1984	30	

Section B.—Long-term Capital Loss Carryover

31 Subtract line 29 from line 25 (**Note:** *If you skipped lines 27 through 30, enter amount from line 25)*	31	
32 Enter loss from line 19; if none, enter zero and skip lines 33 through 36	32	
33 Enter gain shown on line 8. If that line is blank or shows a loss, enter zero	33	
34 Reduce any loss on line 32 to the extent of any gain on line 33	34	
35 Multiply amount on line 31 by 2	35	
36 Subtract line 35 from line 34. This is your long-term capital loss carryover from 1983 to 1984	36	

SCHEDULE E (Form 1040)

Department of the Treasury Internal Revenue Service (0)

Supplemental Income Schedule

(From rents and royalties, partnerships, estates, and trusts, etc.)

▶ Attach to Form 1040. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074

1983

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Name(s) as shown on Form 1040 | Your social security number

PART I.—Rent and Royalty Income or Loss

1 Are any of the expenses listed below for a vacation home or other recreational unit (see Instructions)? . . . . ☐ Yes ☐ No

2 If you checked "Yes" to question 1, did you or a member of your family occupy the vacation home or other recreational unit for more than the greater of 14 days or 10% of the total days rented at fair rental value during the tax year? . . . ☐ Yes ☐ No

Description of Properties (Show kind and location for each)

Property A ....

Property B ....

Property C

Rental and Royalty Income		Properties A	Properties B	Properties C	Totals (Add columns A, B, and C)	
3 a Rents received					3	
b Royalties received						
Rental and Royalty Expenses						
4 Advertising	4					
5 Auto and travel	5					
6 Cleaning and maintenance	6					
7 Commissions	7					
8 Insurance	8					
9 Interest	9					
10 Legal and other professional fees . . .	10					
11 Repairs	11					
12 Supplies	12					
13 Taxes (Do **not** include Windfall Profit Tax here. See Part III, line 37.)	13					
14 Utilities	14					
15 Wages and salaries	15					
16 Other (list) ▶						
....						
....						
....						
....						
....						
....						
....						
....						
....						
17 Total expenses other than depreciation and depletion. Add lines 4 through 16 . . .	17				17	
18 Depreciation expense (see Instructions), or depletion	18				18	
19 Total. Add lines 17 and 18	19					
20 Income or (loss) from rental or royalty properties. Subtract line 19 from line 3a (rents) or 3b (royalties)	20					
21 Add properties with profits on line 20, and write the total profits here					21	
22 Add properties with losses on line 20, and write the total (losses) here					22	( )
23 Combine amounts on lines 21 and 22, and write the net profit or (loss) here					23	
24 Net farm rental profit or (loss) from Form 4835, line 49					24	
25 Total rental or royalty income or (loss). Combine amounts on lines 23 and 24, and write the total here. If Parts II, III, and IV on page 2 do not apply to you, write the amount from line 25 on Form 1040, line 18. Otherwise, include the amount in line 39 on page 2 of Schedule E					25	

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule E (Form 1040) 1983

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side) | Your social security number

PART II.—Income or Losses from Partnerships, Estates or Trusts, or S Corporations

If you report a loss below, and have amounts invested in that activity for which you are not at risk, you may have to file Form 6198. See instructions.

	(a) Name	(b) Check if foreign partnership	(c) Employer identification number	(d) Net loss (see instructions for at-risk limitations)	(e) Net income
Partnerships					
	26 Add amounts in columns (d) and (e) and write the total(s) here		26	( )	
	27 Combine amounts in columns (d) and (e), line 26, and write the net income or (loss)			27	
	28 Deduction for section 179 property (from Form 1065, Schedule K-1). (See Instructions for limitations.)			28	( )
	29 Total partnership income or (loss). Combine amounts on lines 27 and 28. Write the total here and include in line 39 below			29	
Estates or Trusts					
	30 Add amounts in columns (d) and (e) and write the total(s) here		30	( )	
	31 Total estate or trust income or (loss). Combine amounts in columns (d) and (e), line 30. Write the total here and include in line 39 below			31	
S Corporations					
	32 Add amounts in columns (d) and (e) and write the total(s) here		32	( )	
	33 Combine amounts in columns (d) and (e), line 32, and write the net income or (loss) here . . .			33	
	34 Deduction for section 179 property (from Form 1120S, Schedule K-1). (See Instructions for limitations.)			34	( )
	35 Total S corporation income or (loss). Combine amounts on lines 33 and 34. Write the total here and include in line 39 below			35	

PART III.—Windfall Profit Tax Summary

36 Windfall profit tax credit or refund received in 1983 (see Instructions)	36	
37 Windfall profit tax withheld in 1983 (see Instructions)	37	( )
38 Combine amounts on lines 36 and 37. Write the total here and include in line 39 below	38	

PART IV.—Summary

39 TOTAL income or (loss). Combine lines 25, 29, 31, 35, and 38. Write total here and on Form 1040, line 18 ▶			39	
40 Farmers and fishermen: Write your share of GROSS FARMING AND FISHING INCOME applicable to Parts I and II	40			

PART V.—Depreciation Claimed in Part I.—Complete only if property was placed in service before January 1, 1981. For more space, use Form 4562. If you placed any property in service after December 31, 1980, use Form 4562 for all property; do NOT complete Part V.

	(a) Description of property	(b) Date acquired	(c) Cost or other basis	(d) Depreciation allowed or allowable in prior years	(e) Depreciation method	(f) Life or rate	(g) Depreciation for this year
Property A							
	Totals (Property A)			. . . .	. . . .	. . .	
Property B							
	Totals (Property B)			. . . .	. . . .	. . .	
Property C							
	Totals (Property C)			. . . .	. . . .	. . .	

☆ U.S. G.P.O. 1983-390-088 E.I. 43-0787287

SCHEDULE F (Form 1040)
Department of the Treasury
Internal Revenue Service (0)

Farm Income and Expenses

▶ Attach to Form 1040, Form 1041, or Form 1065.
▶ See Instructions for Schedule F (Form 1040).

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Name of proprietor(s) | Social security number

If you disposed of commodities received under the payments-in-kind (PIK) program, check the box(es) that apply: | Employer identification number

☐ Feed for livestock, ☐ Sold and reported in income.

PART I.—Farm Income—Cash Method

Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.

Sales of Livestock and Other Items You Bought for Resale

a. Description	b. Amount	c. Cost or other basis
1 Livestock ▶		
2 Other items ▶		
3 Totals		
4 Profit or (loss), subtract line 3, column c, from line 3, column b ▶		

Sales of Livestock and Produce You Raised and Other Farm Income

Kind		Amount
5 Cattle and calves		
6 Sheep		
7 Swine		
8 Poultry		
9 Dairy products		
10 Eggs		
11 Wool		
12 Cotton		
13 Tobacco		
14 Vegetables		
15 Soybeans		
16 Corn		
17 Other grains		
18 Hay and straw		
19 Fruits and nuts		
20 Machine work		
21 a Patronage dividends		
b **Less:** Nonincome items		
c Net patronage dividends		
22 Per-unit retains		
23 Nonpatronage distributions from exempt cooperatives		
24 Agricultural program payments: a Cash		
b Materials and services		
25 Commodity credit loans under election (or forfeited)		
26 Federal gasoline tax credit		
27 State gasoline tax refund		
28 Crop insurance proceeds		
29 Other (specify) ▶		
30 Add amounts in column for lines 5 through 29		
31 **Gross profits** (add lines 4 and 30) ▶		

PART II.—Farm Deductions—Cash or Accrual Method

Do not include personal or living expenses (such as taxes, insurance, repairs, etc., on your home), which do not produce farm income. Reduce the amount of your farm deductions by any reimbursement before entering the deduction below.

Items	Amount
32 a Labor hired	
b Jobs credit	( )
c Balance (subtract line 32b from line 32a)	
33 Repairs, maintenance	
34 Interest	
35 Rent of farm, pasture	
36 Feed purchased	
37 Seeds, plants purchased	
38 Fertilizers, lime, chemicals	
39 Machine hire	
40 Supplies purchased	
41 Breeding fees	
42 Veterinary fees, medicine	
43 Gasoline, fuel, oil	
44 Storage, warehousing	
45 Taxes	
46 Insurance	
47 Utilities	
48 Freight, trucking	
49 Conservation expenses	
50 Land clearing expenses (see instructions for limitations)	
51 Pension and profit-sharing plans	
52 Employee benefit programs other than line 51	
53 Depreciation and Section 179 deduction (from Form 4562)	
54 Other (specify) ▶	
55 **Total deductions** (add lines 32c through 54) ▶	

56 Net farm profit or (loss) (subtract line 55 from line 31). If a profit, enter on Form 1040, line 19, and on Schedule SE, Part I, line 1. If a loss, go on to line 57. (Fiduciaries and partnerships, see the Instructions.) 56

57 If you have a loss, you must answer this question: "Do you have amounts for which you are not at risk in this farm (see Instructions)?". ☐ Yes ☐ No
If "Yes," you must attach Form 6198. If "No," enter the loss on Form 1040, line 19, and on Schedule SE, Part I, line 1.

For Paperwork Reduction Act Notice, see Form 1040 Instructions. **Schedule F (Form 1040) 1983**

PART III.—Farm Income—Accrual Method (Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797 and omit them from "Inventory at beginning of year" column.)

a. Kind	b. Inventory at beginning of year	c. Cost of items purchased during year	d. Sales during year	e. Inventory at end of year
58 Cattle and calves				
59 Sheep				
60 Swine				
61 Poultry				
62 Dairy products				
63 Eggs				
64 Wool				
65 Cotton				
66 Tobacco				
67 Vegetables				
68 Soybeans				
69 Corn				
70 Other grains				
71 Hay and straw				
72 Fruits and nuts				
73 Machine work				
74 Other (specify) ▶				
75 Totals (enter here and in Part IV below)	(Enter on line 84)	(Enter on line 85)	(Enter on line 77)	(Enter on line 76)

PART IV.—Summary of Income and Deductions—Accrual Method

76 Inventory of livestock, crops, and products at end of year (line 75, column e)

77 Sales of livestock, crops, and products during year (line 75, column d)

78 Agricultural program payments: a Cash

b Materials and services

79 Commodity credit loans under election (or forfeited)

80 Federal gasoline tax credit

81 State gasoline tax refund

82 Other farm income (specify) ▶

83 Add lines 76 through 82

84 Inventory of livestock, crops, and products at beginning of year (line 75, column b)

85 Cost of livestock and products purchased during year (line 75, column c)

86 Total (add lines 84 and 85)

87 **Gross profits** (subtract line 86 from line 83)

88 Total deductions from Part II, line 55 ▶

89 Net farm profit or (loss) (subtract line 88 from line 87). If a profit, enter on Form 1040, line 19, and on Schedule SE, Part I, line 1. If a loss, go on to line 90. (Fiduciaries and partnerships, see the Instructions.) 89

90 If you have a loss, you must answer this question: "Do you have amounts for which you are not at risk in this farm (see Instructions)?". ☐ **Yes** ☐ **No**
If "Yes," you must attach Form 6198. If "No," enter the loss on Form 1040, line 19, and on Schedule SE, Part I, line 1.

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SCHEDULE SE (Form 1040)
Department of the Treasury
Internal Revenue Service (0)

Computation of Social Security Self-Employment Tax

▶ See Instructions for Schedule SE (Form 1040).
▶ Attach to Form 1040.

OMB No. 1545-0074

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Name of self-employed person (as shown on social security card) | Social security number of self-employed person ▶

PART I.—Regular Computation of Net Earnings from Self-Employment

1 Net profit or (loss) from Schedule F (Form 1040), line 56 or line 89, and farm partnerships, Schedule K-1 (Form 1065), line 18b	1		
2 Net profit or (loss) from Schedule C (Form 1040), line 32, and Schedule K-1 (Form 1065), line 18b (other than farming). See instructions for kinds of income to report. **Note:** If you are exempt from self-employment tax on your earnings as a minister, member of a religious order, or Christian Science practitioner because you filed Form 4361, check here ▶ ☐. If you have other earnings of $400 or more that are subject to self-employment tax, include those earnings on this line	2		

PART II.—Optional Computation of Net Earnings from Self-Employment

Generally, this part may be used **only** if you meet any of the following tests:

A Your gross farm profits (Schedule F (Form 1040), line 31 or line 87) were not more than $2,400, or

B Your gross farm profits (Schedule F (Form 1040), line 31 or line 87) were more than $2,400 and your net farm profits (Schedule F (Form 1040), line 56 or line 89) were less than $1,600, or

C Your net nonfarm profits (Schedule C (Form 1040), line 32) were less than $1,600 and also less than two-thirds (⅔) of your gross nonfarm income (Schedule C (Form 1040), line 5).

See instructions for other limitations.

3 Maximum income for optional methods	3	$1,600	00
4 Farm Optional Method—If you meet test A or B above, enter: two-thirds (⅔) of gross profits from Schedule F (Form 1040), line 31 or line 87, and farm partnerships, Schedule K-1 (Form 1065), line 18a, or $1,600, whichever is smaller	4		
5 Subtract line 4 from line 3	5		
6 Nonfarm Optional Method—If you meet test C, enter: the smaller of two-thirds (⅔) of gross nonfarm income from Schedule C (Form 1040), line 5, and Schedule K-1 (Form 1065), line 18c (other than farming), or $1,600, or, if you elected the farm optional method, the amount on line 5	6		

PART III.—Computation of Social Security Self-Employment Tax

7 Enter the amount from Part I, line 1, or, if you elected the farm optional method, Part II, line 4			7		
8 Enter the amount from Part I, line 2, or, if you elected the nonfarm optional method, Part II, line 6			8		
9 Add lines 7 and 8. If less than $400, you are not subject to self-employment tax. Do not fill in the rest of the schedule			9		
10 The largest amount of combined wages and self-employment earnings subject to social security or railroad retirement tax (Tier I) for 1983 is			10	$35,700	00
11 a Total social security wages from Forms W-2 and railroad retirement compensation (Tier I). **Note:** U.S. Government employees whose wages are only subject to the 1.3% hospital benefits tax (Medicare) should not include those wages on this line (see instructions)	11a				
b Unreported tips subject to social security tax from Form 4137, line 9, or to railroad retirement tax (Tier I)	11b				
c Add lines 11a and 11b			11c		
12 Subtract line 11c from line 10			12		
13 Enter the smaller of line 9 or line 12			13		
If line 13 is $35,700 or more, fill in $3,337.95 on line 14. Otherwise, multiply line 13 by .0935 and enter the result on line 14				.0935	
14 Self-employment tax. Enter this amount on Form 1040, line 50			14		

For Paperwork Reduction Act Notice, see Form 1040 Instructions. **Schedule SE (Form 1040) 1983**

Form **4797**

Department of the Treasury
Internal Revenue Service (0)

Supplemental Schedule of Gains and Losses

(Includes Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business and Involuntary Conversions)

▶ To be filed with Form 1040, 1041, 1065, 1120, etc.—See Separate Instructions

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Name(s) as shown on return | Identifying number

PART I.—Sales or Exchanges of Property Used in a Trade or Business, and Involuntary Conversions From Other Than Casualty and Theft — Property Held More Than 1 Year (Except for Certain Livestock)

Note: *Use Form 4684 to report involuntary conversions from casualty and theft.*

Caution: *If you sold property on which you claimed the investment credit, you may be liable for recapture of that credit. See Form 4255 for additional information.*

a. Description of property	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price	e. Depreciation allowed (or allowable) since acquisition	f. Cost or other basis, plus improvements and expense of sale	g. LOSS (f minus the sum of d and e)	h. GAIN (d plus e minus f)
1							

2 Gain, if any, from Form 4684, line 27		
3 Section 1231 gain from installment sales from Form 6252, line 21 or 29		
4 Gain, if any, from line 29, Part III, on back of this form from other than casualty and theft.		
5 Add lines 1 through 4 in column g and column h	( )	
6 Combine columns g and h of line 5. Enter gain or (loss) here, and on the appropriate line as follows:		

(a) For all except partnership returns:

(1) If line 6 is a gain, enter the gain as a long-term capital gain on Schedule D. See instruction E.

(2) If line 6 is zero or a loss, enter that amount on line 7. (S corporations, enter on Schedule K (Form 1120S), line 7.)

(b) For partnership returns: Enter each partner's share of line 6 above, on Schedule K-1 (Form 1065), line 8.

PART II.—Ordinary Gains and Losses

a. Description of property	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price	e. Depreciation allowed (or allowable) since acquisition	f. Cost or other basis, plus improvements and expense of sale	g. LOSS (f minus the sum of d and e)	h. GAIN (d plus e minus f)
7 Loss, if any, from line 6(a)(2)							
8 Gain, if any, from line 28, Part III on back of this form							
9 Net gain or (loss) from Form 4684, lines 19 and 26a							
10 Ordinary gain from installment sales from Form 6252, line 20 or 28							
11 Recapture of section 179 deduction (see instructions)							
12 Other ordinary gains and losses (include property held 1 year or less):							
13 Add lines 7 through 12 in column g and column h						( )	

14 Combine columns g and h of line 13. Enter gain or (loss) here, and on the appropriate line as follows:

(a) For all except individual returns: Enter the gain or (loss) from line 14, on the return being filed. See instruction F for specific line reference.

(b) For individual returns:

(1) If the loss on line 7 includes a loss from Form 4684, Part II, column B(ii), enter that part of the loss here and on line 21 of Schedule A (Form 1040). Identify as from "Form 4797, line 14(b)(1)".

(2) Redetermine the gain or (loss) on line 14, excluding the loss (if any) on line 14(b)(1). Enter here and on Form 1040, line 15

For Paperwork Reduction Act Notice, see page 1 of separate Instructions.

Form **4797** (1983)

PART III.—Gain From Disposition of Property Under Sections 1245, 1250, 1251, 1252, 1254, 1255

Skip lines 23 and 24 if you did not dispose of farm property or farmland, or if a partnership files this form.

15 Description of sections 1245, 1250, 1251, 1252, 1254, and 1255 property:	Date acquired (mo., day, yr.)	Date sold (mo., day, yr.)
(A)		
(B)		
(C)		
(D)		

Relate lines 15(A) through 15(D) to these columns ▶ ▶ ▶ ▶	Property (A)	Property (B)	Property (C)	Property (D)
16 Gross sales price				
17 Cost or other basis plus expense of sale				
18 Depreciation (or depletion) allowed (or allowable)				
19 Adjusted basis, subtract line 18 from line 17				
20 Total gain, subtract line 19 from line 16				
21 If section 1245 property:				
(a) Depreciation allowed (or allowable) after applicable date (see instructions)				
(b) Enter smaller of line 20 or 21(a)				
22 If section 1250 property: (If straight line depreciation used, enter zero on line 22(f).)				
(a) Additional depreciation after 12/31/75				
(b) Applicable percentage times the smaller of line 20 or line 22(a) (see instruction G.4)				
(c) Subtract line 22(a) from line 20. If line 20 is not more than line 22(a), skip lines 22(d) and 22(e)				
(d) Additional depreciation after 12/31/69 and before 1/1/76				
(e) Applicable percentage times the smaller of line 22(c) or 22(d) (see instruction G.4)				
(f) Add lines 22(b), and 22(e)				
23 If section 1251 property:				
(a) If farmland, enter soil, water, and land clearing expenses for current year and the four preceding years				
(b) If farm property other than land, subtract line 21(b) from line 20; if farmland, enter smaller of line 20 or 23(a)				
(c) Excess deductions account (see instruction G.5)				
(d) Enter smaller of line 23(b) or 23(c)				
24 If section 1252 property:				
(a) Soil, water, and land clearing expenses				
(b) Amount from line 23(d), if none enter zero				
(c) Subtract line 24(b) from line 24(a). If line 24(b) is more than line 24(a), enter zero				
(d) Line 24(c) times applicable percentage (see instruction G.5)				
(e) Subtract line 24(b) from line 20				
(f) Enter smaller of line 24(d) or 24(e)				
25 If section 1254 property:				
(a) Intangible drilling and development costs deducted after 12/31/75 (see instruction G.6)				
(b) Enter smaller of line 20 or 25(a)				
26 If section 1255 property:				
(a) Applicable percentage of payments excluded from income under section 126 (see instruction G.7)				
(b) Enter the smaller of line 20 or 26(a)				

Summary of Part III Gains (Complete Property columns (A) through (D) through line 26(b) before going to line 27)

27 Total gains for all properties (add columns (A) through (D), line 20)	
28 Add columns (A) through (D), lines 21(b), 22(f), 23(d), 24(f), 25(b) and 26(b). Enter here and on Part II, line 8	
29 Subtract line 28 from line 27. Enter the portion from casualty and theft on Form 4684, line 21; enter the portion from other than casualty and theft on Form 4797, Part I, line 4	

PART IV.—Complete this Part Only if You Elect Out of the Installment Method And Report a Note or Other Obligation at Less Than Full Face Value

☐ Check here if you elect out of the installment method.

Enter the face amount of the note or other obligation ▶ ____________

Enter the percentage of valuation of the note or other obligation ▶ ____________

Form **4835**

Department of the Treasury
Internal Revenue Service

Farm Rental Income and Expenses

(Crop and Livestock Shares Received by Nonparticipating Landowner (or Sub-lessor))

(Income not subject to self-employment tax)

▶ Attach to Form 1040.

OMB No. 1545-0187

1983

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Name(s) as shown on Form 1040

Social security number

If you filed Form 943, enter employer identification number here

Purpose of Form.—Use this form to report farm rental income based on crops or livestock produced by the tenant if you were the landowner (or sub-lessor), and did not materially participate in the operation or management of the farm.

Under both the cash and the accrual methods of reporting, you must report livestock or crop share rentals received in the year in which you convert them into money or its equivalent.

Landowners (or sub-lessors) must not use this form to report cash rent received for pasture, or farmland, if the amount is based on a flat charge. Report this income directly on Schedule E (Form 1040).

PART I.—Gross Farm Rental Income—Based on Production

(Include amount converted to cash or the equivalent)

	Kind	Amount
1	Cattle and calves	
2	Sheep	
3	Swine	
4	Poultry	
5	Dairy products	
6	Eggs	
7	Wool	
8	Cotton	
9	Tobacco	
10	Vegetables	
11	Soybeans	
12	Corn	
13	Other grains	
14	Hay and straw	
15	Fruits and nuts	
16 a	Patronage dividends	
b	**Less:** Nonincome items	
c	Net patronage dividends	
17	Per-unit retains	
18	Agricultural program payments:	
a	Cash	
b	Materials and services	
19	Commodity credit loans under election (or forfeited)	
20	Federal gasoline tax credit	
21	State gasoline tax refund	
22	Crop insurance proceeds	
23	Other (specify) ▶	
24	**Gross farm rents** (add lines 1 through 23) ▶	

PART II.—Deductions—Farm Rental Property

(Exclude personal and living expenses)

	Items	Amount
25 a	Labor hired (see Schedule F Instructions)	
b	Jobs credit	( )
c	Subtract line 25b from line 25a	
26	Repairs, maintenance	
27	Interest	
28	Rent of farm, pasture	
29	Feed purchased	
30	Seeds, plants purchased	
31	Fertilizers, lime, chemicals	
32	Machine hire	
33	Supplies purchased	
34	Breeding fees	
35	Veterinary fees, medicine	
36	Gasoline, fuel oil	
37	Storage, warehousing	
38	Taxes	
39	Insurance	
40	Utilities	
41	Freight, trucking	
42	Conservation expenses	
43	Land clearing expenses (see Schedule F Instructions for limitations)	
44	Pension and profit-sharing plans (see Schedule F Instructions)	
45	Employee benefit programs other than line 44 (see Schedule F Instructions)	
46	Depreciation and Section 179 deduction (from Form 4562)	
47	Other (specify) ▶	
48	**Total deductions** (add lines 25c through 47) ▶	

49	Net farm rental profit or (loss) (subtract line 48 from line 24). If a profit, enter here and on Schedule E (Form 1040), Part I, line 24. If a loss, go on to line 50 before you enter the loss here and on Schedule E (Form 1040)	

50 If you have a loss, you must answer this question: "Do you have amounts for which you are not at risk in this farm (see Instructions for Schedule F)?" ☐ Yes ☐ No

If you checked "Yes," you must attach Form 6198. If you checked "No," enter the loss on Schedule E, Part I, line 24.

For Paperwork Reduction Act Notice, see back of Form 4835.

Form **4835** (1983)

General Information

Paperwork Reduction Act Notice

We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Note: *Tenants must not use this form to report farm income and expenses. (Individuals use Schedule F (Form 1040).)*

Line-by-Line Instructions

PART I.—Gross Farm Rental Income—Based on Production

Lines 1 through 15

For each kind of livestock and crop, report income you received based on production. Include amounts converted to cash or the equivalent.

Line 16

Patronage dividends are profits from a farming co-op. See Schedule F instructions.

Line 17

Per-unit retains are amounts held for you by a farming co-op. See Schedule F instructions.

Lines 18 through 23

Include agricultural program payments, certain loans, credits and refunds, and other payments.

PART II.—Deductions—Farm Rental Property

Lines 25 through 45

Report expenses listed. Do not include personal and living expenses.

If you report both farm rental income on line 24 of this form and cash rental income from farm property in Schedule E (Form 1040), you do not have to prorate the farm expenses that apply to this farm rental income. Instead, you may report the total farm rental expenses in Part II of this form.

Line 46

Use **Form 4562,** Depreciation and Amortization, to figure your depreciation deduction. If you are choosing to expense certain recovery property (section 179), also use Form 4562 to figure this deduction. For more information on depreciation and the election to expense certain recovery property, see Schedule F instructions.

Enter on line 46 of Form 4835 the amount of the deduction from Form 4562, Part I.

Line 47

Enter expenses not listed on another line. See Schedule F instructions.